



To: U.S. Senate Finance Committee
“Business Income Tax” and “Savings & Investment” Working Groups

From: Small Business Investor Alliance

Date: April 15, 2015

On behalf of the Small Business Investor Alliance (SBIA), we commend the Senate Finance Committee (the Committee) on its approach to tax reform by forming working groups to review current law and compile feedback from the public. We appreciate the opportunity to make comments to the Business Income Tax and Savings & Investment Working Groups.

About the Small Business Investor Alliance (SBIA)

SBIA is the premier organization of lower middle market private equity funds and investors. SBIA members provide vital capital to growing small- and medium-sized businesses nationwide, resulting in job creation and economic growth. SBIA member funds employ various strategies including growth equity, mezzanine, debt, buyout, unitranche, and venture capital. These lower middle market funds invest long-term capital in domestic small businesses in nearly every state across the country.

Most members of SBIA are private equity partnerships, which are structured as pass-through entities for tax purposes, pooling capital from limited partners to invest in companies nationwide. About half of SBIA member funds are licensed as Small Business Investment Companies (SBICs). A growing number of SBIA members are Business Development Companies (BDCs), which are Securities and Exchange Commission (SEC)-regulated investment vehicles that are structured as Regulated Investment Companies (RICs) for tax purposes.

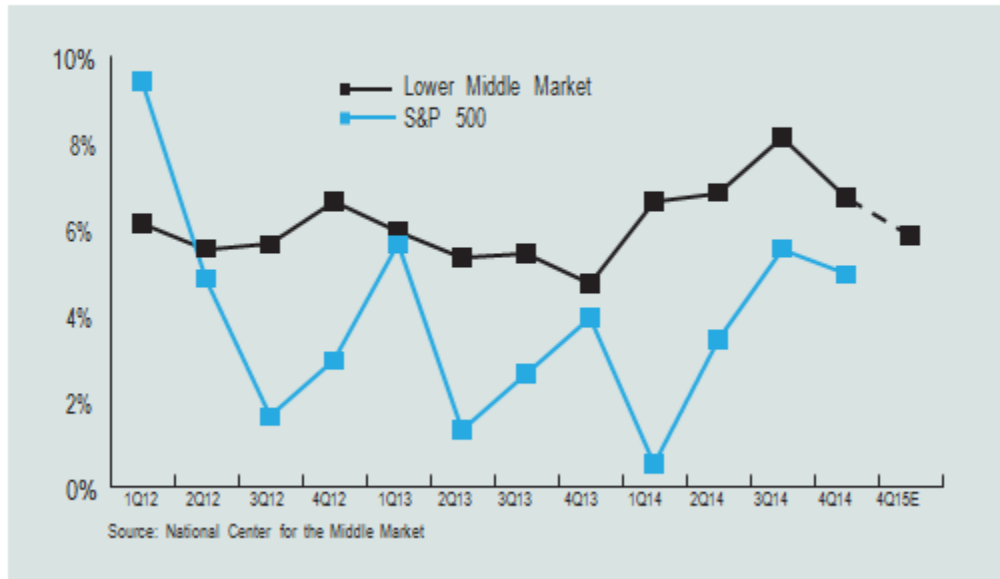
I. Private Equity Creates Jobs

Small businesses that are backed by private equity have an undeniable impact on job creation and revenue growth. According to a 2012 Pepperdine University study, over a five year period after a financing event, private equity-backed companies generated 129 percent more revenue growth and 257 percent more employment growth than their non-private equity-backed counterparts.¹

¹ Paglia, John and Maretno Harjoto. “Did They Build That? The Role of Private Equity and Venture Capital in Small and Medium Sized Businesses.” Graziado School of Business and Management, Pepperdine University,

SBIA members primarily invest their capital in “lower middle market” businesses, which are small businesses that generate between \$10 and \$100 million in revenue per year. Middle market companies account for one-third of private U.S. employment, or 45 million jobs. According to research conducted by the National Center for the Middle Market, middle market companies have recently been the strongest sector of the economy in terms of revenue and employment growth, with annual revenue growth of 6.6 percent and annual employment growth of 3.2 percent in 2014.²

Revenue Growth (Lower Middle Market Businesses vs. S&P 500 Companies)



Revenue growth for lower middle market companies has been significantly more stable and higher than for larger firms included within the S&P 500 index. In 2015, smaller companies expect to continue growing revenues at about a six-percent rate, which is higher than expectations for S&P 500 companies.

<http://bschool.pepperdine.edu/newsroom/wp-content/uploads/2012/12/Paglia-Harjoto-PE-VC-11.29.2012-IEGC.pdf>

²Data retrieved from National Center for the Middle Market: <http://www.middlemarketcenter.org/performance-data-on-the-middle-market>

Employment Growth (Lower Middle Market Businesses vs. Large Corp. (ADP))



Employment growth at lower middle market businesses was in line with large businesses for most of 2013, before taking a sharp upward turn in the first half of 2014. Employment prospects for smaller businesses entering 2015 continue to be robust with projections greater than four-percent.

II. Tax Policies Should Promote -Not Inhibit- Small Business Investment

As the Committee discusses and makes comprehensive changes to the tax code, we urge you to look carefully at how new tax rules will impact long-term capital investments in America's small businesses. Tax policies should promote small business investment, not inhibit investing in small businesses. The Committee should also be mindful of the differences between smaller funds and larger funds when crafting and implementing these policies.

A. Scale Matters in Small Business Investing

Scale matters in small business investing; in particular, amongst members of SBIA that are smaller private equity funds that are more likely to invest in smaller businesses, the businesses that drive most job creation in the United States. It is a consistent problem that policymakers do not consider the impact on small business investing when developing tax policy. Small funds are more likely to deploy capital investments in sizes that smaller companies can absorb and use to grow. This is due to the associated origination costs with smaller financings. It is not cost effective for large funds to do smaller deals as they can generate the same amount of return with a smaller number of larger deals, without the origination costs of multiple smaller deals. Alternatively, smaller funds have less capital to deploy and less overhead, so it is more

cost effective to originate smaller deals. Additionally, smaller funds seek to build a diversified portfolio of investments; the manager of a \$100 million fund would typically seek to allocate those funds to 15 or 20 investments in different companies. Smaller private equity funds fulfill the needs of small businesses by providing access to private long-term debt and equity capital, which is essential to growing and creating jobs.

B. Lower Middle Market Investors Have a National Impact

It is important to note that most of the investments that are made by smaller private equity funds, SBICs and BDCs, are in companies located in areas of the country underserved by large private equity funds. This point was made clear in a recent report issued by the Small Business Administration (SBA) regarding SBICs.³ The SBA report identified that the largest private equity funds concentrate 51-percent of their investment in only 15 U.S. counties. In contrast, 75-percent of SBIC investments fall outside those top 15 U.S. counties.

The companies that employ your constituents have received capital from SBIA members, resulting in a strong, lasting, and positive impact on the communities in your state. Currently, over \$22 billion is invested by SBICs in small businesses nationwide, with a further \$70 billion invested nationwide in companies by BDCs. For example, BDCs have made investments valued at approximately \$99 billion in Wyoming, \$1.2 billion in Utah, \$77 million in Idaho, and \$494 million in Oregon. Over the past five years, SBICs have invested \$141 million in Oregon companies, \$256 million in Utah companies, \$218 million in Washington companies, \$47 million in South Dakota companies, and \$69 million in Iowa companies.

As you can see, smaller private equity funds touch areas of the country that desperately need capital. To facilitate further capital formation to these parts of the country, we urge you to pass policies that promote small business investing. Tax policies that are punitive to smaller funds will only result in less capital being deployed to underserved areas of the country, stifling job creation and economic growth.

III. Carried Interest is Critical to Sustain Small Business Investors

There is no area that has been so regularly overlooked as the disparate impact of changing carried interest on small business investment funds. Effectively all of the debate on carried interest has surrounded managers of the largest, multibillion dollar, multinational funds and there has been almost no review of the impact of funds investing in domestic small businesses. Yet, it is these small business investors that will bear the brunt of a tax increase.

³ Small Business Investment Company Program, Annual Report for Fiscal Year Ending September 30, 2013, at 17.

Available at:

https://www.sba.gov/sites/default/files/files/Final_SBIC_Annual_Report_FY_2013_signed_06092014.pdf

Private Equity investing involves investing long-term, patient capital that provides a return years after the initial investment is made. As a result of the long-term nature of these investments, the returns from these investments are treated as long-term capital gains under the tax code and are, therefore, taxed at a lower rate than regular income. This concept is known as “carried interest.” Through this investing structure, the general partner (GP) is compensated through “carry” only if the fund is successful, as investors must receive back the value of their initial investment, as well as a certain specified profit percentage, before the GP receives their return. In this manner, the GP’s economic interests are aligned with those of the investors in the fund, ensuring performance benchmarks are met.

Any changes to the tax treatment of carried interest will damage smaller private equity funds. Unlike the largest funds, smaller funds commonly have over 70% of their potential return at risk in the carry while the largest funds may only have 20% at risk. Having 70% of your potential return at risk for 10 years is clearly long-term, risk capital. If performance measures are not achieved or exceeded, the smaller fund manager may receive nothing in the carry.

For smaller funds, if the carried interest tax rate increases dramatically, it makes less sense economically to operate a fund. The smaller the fund, the less it will be able to withstand an increase in the tax rate for carried interest because smaller funds cannot survive solely on asset-based management fees.⁴ For smaller funds, the carried interest locks in an unmatched incentive to perform at the highest levels for their investors (commonly pension funds and endowments). Because they are earning fees on much smaller pools of capital, managers of smaller funds can only create wealth for themselves if they create even greater wealth for their investors. This healthy alignment of interest is shattered if the carry is removed. As a result, there will be fewer smaller investment funds and, therefore, less capital available for small businesses around the country.

In the past, there have been several attempts to change the tax treatment of carried interest from capital gains to ordinary income. For example, for the sixth time in a row, the Treasury Department’s revenue proposals have recommended permanently changing the tax treatment of carried interest. Let’s not forget that there are over 1,000 private equity funds that specialize in investing in America’s small businesses. These are not the billionaire fund managers that are widely mentioned and quoted in newspapers. These are the fund managers

⁴ Most advisers to private equity funds charge a 2% management fee, which is based on the assets under management within the fund. This money is used to operate the fund, pay staff salaries, ensure regulatory compliance, and source investment opportunities. For example, a fund with \$20 million in assets under management (AUM) would charge \$400,000 annually to operate the fund, pay salaries, and source investment opportunities.

that run small operations in states like Arkansas, Georgia, Kansas, Iowa, Oregon, and Utah. If these fund managers are taxed out of business, they will be prevented from making investments in small businesses across the country, and private equity for small business capital formation will once again be concentrated only in large urban centers on the coasts.

IV. The Committee Must Preserve Partnership Taxation in the Tax Code

For tax purposes, private equity partnerships are considered pass-through entities and partners file individual taxes. The partnership section of the tax code is unique in that it allows GPs efficiently to pool capital from limited partners and deploy it to businesses. No other structure of the tax code encourages capital formation better than the partnership section. Partnership rules should be preserved to encourage the formation of partnerships for small business investment in the future.

We urge the committee to be mindful that making changes to the partnership section of the tax code may result in significant new costs and compliance burdens on private equity funds. Any new compliance cost would hit smaller funds disproportionately because they are less likely to have the resources to take on new compliance burdens.

A. Avoid Imposition of Tax Withholding at the Partnership Level

During consideration of a partnership discussion draft proposed by the House Ways and Means Committee in 2013, there were several provisions that would have been damaging to private equity partnerships. First, the discussion draft proposed tax withholding on partnerships on their distributive share of pass-through income. Withholding at the partnership entity level would have added a significant new administrative burden for private equity partnerships. The fluctuations of investment income, gain, and loss, as well as the complexities of the makeup of a limited partnership, make withholding at the partnership entity level highly complex. Unlike an income transaction between an employer and employee where estimated income is highly predictable, the income into a private equity fund changes based on the life of the fund and success of the investments. From an investor perspective, the investor may well have offsetting losses which would result in the taxpayer not owing any taxes. This would place the taxpayer in the position of having to file for a refund for taxes unnecessarily withheld.

B. Avoid Changes to the Partnership Allocation Rules

Second, the Ways and Means discussion draft would have made significant changes to the partnership allocation rules, placing restrictions on providing different distributive shares of pass-through items within a particular category. Partnerships rely on these rules to make different levels of contributions to different portfolio companies. SBIA understands certain

partnership rules should be tightened to prevent tax schemes, but, for cases in which there is a real economic effect, the partnership tax code should remain flexible.

V. Encourage Qualified Small Business Investment in the Tax Code

One way that the Committee can strengthen its commitment to small businesses is to make permanent lower capital gains rates for long-term investments in qualified small businesses (QSB). Section 1202 of the tax code, which provides an exclusion for investments in QSBs, is an excellent feature of the tax code designed to encourage investments in small businesses. However, this provision can be made even more effective for small business investment if certain changes are made to expand its usefulness. SBIA recommends making a number of changes to the law that would modernize and simplify the QSB provision.

The current definition of QSB is too limited. For example, the definition only applies to C-corporation stock investments held for more than five years. There are also industry limitations (hotels and oil and gas businesses are not eligible), and warrants are not eligible investments. Taken together, these limitations make it more difficult for the investor to identify eligible investments.

SBIA recommends making the following changes to expand the usefulness of the 1202 provision:

- 1) Modernize the definition of QSB to include LLCs and LLPs and to include all investments consistent with the definition of small business under the Small Business Investment Act of 1959 (as amended). LLC and LLP structures are much more common legal structures than they were in 1993 when Section 1202 was passed into law.
- 2) Clarify that small business stock can include stock acquired upon the exercise of warrants. This would reduce the initial cost of capital for small businesses by adding equity to a debt deal.
- 3) Allow investors that sell QSB stock held over three years to defer recognition of capital gains by reinvesting the sale proceeds in new QSB stock within six months. This would encourage repeat investors to invest in more than one small business.
- 4) Increase the gross asset test in the QSB definition from \$50 to \$75 million and index for inflation. This update of the definition of QSB will keep up with the growth of the economy.

VI. The Committee Should Maintain the Deductibility of Interest on Debt

We encourage the committee to maintain interest on debt as an ordinary business expense under the tax code because businesses rely on debt to finance their operations and grow. Debt

is a fundamental element of a typical company's capital structure and is often used to finance business activities like meeting payroll, buying raw materials, making capital expenditures, and acquiring new business ventures.

Removing or severely limiting the deductibility of interest expense would be extremely damaging to small businesses for two reasons. First, debt is a critical and accessible form of capital for businesses. Second, removing the deductibility of interest expense would shift businesses to accessing capital via equity, which means business owners would have to sell a piece of their business to access capital. If a business wants to access capital via an equity offering, and many do, that should be their choice, but Congress should not be unintentionally pushing businesses into positions where they are losing part of their company and part of the control of their business.

According to a National Federation of Independent Business (NFIB) survey on Small Business Credit Access, the most frequent purpose for businesses attempting to take on debt is to support cash flow (63%). Those attempting to borrow for investments in plant, equipment, or vehicles totaled 37% and those attempting to borrow to invest in inventory totaled 38%.⁵ This NFIB study proves that debt financing is critical to providing cash on demand to support, invest, and grow business operations.

Companies looking to finance investment with debt undergo rigorous due diligence from their creditors. This due diligence pays off because it is a process that weeds out potential bad investments and helps ensure against default. Small business investors invest long-term patient capital, including debt, to provide the best opportunity and flexibility for the company to grow and create jobs.

The tax code treats interest on debt as an ordinary business expense that is fully deductible from a company's taxable income. Interest is incurred in the ordinary course of a trade or business, and it should continue to be treated the same as any other ordinary business expense for tax purposes. It is also worth noting that allowing the deduction of interest aligns the tax code with generally accepted accounting principles (GAAP).

Placing limits on the deductibility of business interest would harm domestic investment and have an adverse effect on financing business activities. Limiting the deductibility of interest would also penalize the growth of smaller or more dynamic companies that are reliant upon external financing to manage cash flow, innovate, expand, and create jobs.

⁵ William J. Dennis, Jr. NFIB Research Foundation. Small Business, Credit Access, and a Lingering Recession, January 2012. <http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/small-business-credit-study-nfib-2012.pdf>

A 2012 study by Ernst & Young LLP found that limiting the deductibility of corporate interest would increase the tax cost of investing by substantially more than the corresponding reduction in the corporate tax rate. The higher cost of investments from limiting interest deductibility, even with a revenue neutral reduction in corporate tax rates, would hamper U.S. investment. The Ernst & Young study also found that by lowering the corporate income tax rate, the deductibility of interest expenses would increase the marginal effective tax rate on new corporate investment from 31.0 percent to 33.1 percent – a 6.7% increase in the marginal effective tax rate.⁶

VII. The Committee Should Make Improvements to Regulated Investment Companies (RICs)

SBIA supports making permanent a tax provision that incentivizes and attracts foreign investment in domestic BDCs which are an important source of capital for small and medium size companies. BDCs are regulated investment companies that were created in 1980 by Congress to spur investment in and provide a new source of capital for domestic small and mid-sized businesses. BDCs allow retail investors the opportunity to invest in a portfolio of private small and mid-sized companies by purchasing shares in the BDC. For tax purposes, BDCs are structured as RICs, which are pass-through taxable entities requiring BDCs to pass through at least 90 percent of their income to shareholders each year.

Section 871 of the tax code inhibits foreign investment in BDCs by requiring 30 percent withholding of any interest to be paid to foreign investors of RICs. Legislation is needed to reduce permanently these taxes, thereby encouraging more foreign investment in BDCs.

Incentivizing foreign capital to invest in BDCs will allow more capital for American job creation and business growth and help the industry mature to reach its full potential. Not only will this encourage foreign investment, it will give BDCs the ability to rely on a more stable flow of investment from abroad; thus, allowing them to pursue more confidently and aggressively their interests without the uncertainty of losing such investment due to a gap of withholding protection. Foreign investors will also be able to ensure that their long-term investment plans will not be inhibited by tax barriers.

VIII. Conclusion

SBIA appreciates the opportunity to comment to the Senate Finance Committee Tax Reform Working Groups, and looks forward to working with you on passing tax policies that prioritize job creation and small business investment. Thank you again for allowing an open process to hear from the public on tax reform.

⁶ Drs. Robert Carroll and Thomas Neubig, Ernst & Young LLP. *Business Tax Reform and the Tax Treatment of Debt: Revenue Neutral Rate Reduction Financed by an Across-The-Board Interest Deduction Limit Would Deter Investment*. May 2012.

If you have any questions, please contact Chris Walters at cwalters@sbia.org or (202) 628-5055 to set up a time to discuss any of the issues presented in this document.

Sincerely,

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