SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

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VIA ELECTRONIC TRANSMISSION

U.S. Department of the Treasury
Internal Revenue Service
CC:PA:LPD:PR (REG-115420-18)
1111 Constitution Ave., N.W.
Washington, D.C. 20224

RE: Investing in Qualified Opportunity Funds (QOFs)

On behalf of its membership, the Small Business Investor Alliance ("SBIA") is pleased to submit the following comments in response to the notice of proposed rulemaking under new Section 1400Z-2 of the Internal Revenue Code ("Code") that detail intended regulations to allow taxpayers to elect to defer certain gains from federal income taxation provided those gains are timely invested in a Qualified Opportunity Fund ("QOF").[1] The SBIA is the national organization that represents small business private equity funds and their investors, including Small Business Investment Companies ("SBICs") and banks that invest in them.

The statutory purpose underpinning the proposed QOF regulations is to encourage sustained economic growth and investment in designated distressed communities ("Opportunity Zones" or "OZs") by providing federal tax benefits to taxpayers who invest in businesses located within those OZs ("qualified opportunity zone business" or "QOZB").

If the goal of Opportunity Zones is to bring prosperity and economic opportunity to parts of America that lack both, then there is no better example of the type of investments that the QOFs seek to make than the mission-driven, job-creating small business investments made by SBIC funds.

This comment letter presents a summary of the SBIC program administered by the U.S. Small Business Administration ("SBA") and offers observations about the proposed QOF regulations drawn from the long history of the SBIC program.

The Results-Driven Purpose of SBICs Parallels QOFs

The 60-year-old SBIC program is a market-driven platform that serves an important public purpose of facilitating private investment into domestic small businesses.[2] Congress declared generally in authorizing legislation that the SBIC program would "stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations" while also stimulating the national economy and job growth.[3]

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[1] 26 U.S.C. 1400Z-2 (2017).

[2] The U.S. Department of Agriculture operates a similar program for rural economic development. The **Rural Business Investment Company ("RBIC") Program** is a developmental venture capital program for the purpose of promoting economic development and the creation of wealth and job opportunities in non-metropolitan areas and among residents living in those areas. Like the SBA, the USDA selects and licenses RBIC applicants that will agree to address the unmet equity capital needs of small enterprises primarily located in rural areas. 7 U.S.C. 1989 and 2009cc *et seq.* (2017).

[3] Small Business Investment Act of 1958, Pub. L. 85-699 (Aug. 21, 1958). 15 U.S.C. 661.

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During FY18, the SBIC program included more than 300 licensed funds that supported about 1,150 small businesses with $5.5 billion in financing.[4] Companies that in their early stages received SBIC investments and have subsequently grown into icons of American industry include Federal Express, Apple, Intel, and Callaway Golf. Many more small businesses backed by SBICs have grown from "mom-and-pop" shops into robust, sustainable mid-sized businesses that bring prosperity and employment to communities across the country.

SBIC Program Structure and Operations Can Inform QOFs

SBICs are privately-owned and managed investment funds that invest exclusively in domestic small business. SBICs invest private capital that is enhanced by accessing an SBA-backed credit facility using the Federal Home Loan Bank system. This permits individual SBICs to multiply paid-in capital up to three-times or $175 million, whichever is less, while the maximum leverage for an SBIC family of funds is currently $350 million. This public-private partnership structure where private capital leads and the SBA-leverage follows provides SBICs a deeper capital pool from which to make equity and debt investments in qualifying small businesses. These investments are in real companies with real staying power and real growth potential.

SBICs, which are structured as corporations, limited partnerships, or limited liability companies, provide long-term loans, debt-equity investments, and management assistance to small businesses across a range of sectors, geographic locations, and stages of growth. Some SBICs specialize in an industry sector while others invest more broadly. There are various forms of SBICs:

- *Leveraged SBICs* increase the amount of capital available for domestic small business investing by accessing the SBIC credit facility. The leverage is at the fund level.

- *Non-leveraged SBICs* typically include bank-owned SBIC funds or SBIC funds that primarily have banks as their limited partners. These SBIC funds do not seek or receive SBA leverage.

Unlike QOFs, SBICs cannot self-certify and must complete an extensive licensure process conducted by the SBA. One of the principal reasons for this rigorous process is to screen applicants for qualified management capacities. SBIC applicants must demonstrate a strong investment track record, professional skills and character, and ability to execute successful exist strategies from their funds for portfolio companies. While SBIC licensing is a multi-step, months-long process, the benefits it offers by limiting risk and mitigating against bad actors are significant. SBICs are not just reviewed for their financial performance, but also for their investment record of growing and supporting small businesses.

A recent independent study prepared for the Library of Congress found that SBIC-backed small businesses created almost three million new jobs and supported an additional 6.5 million jobs over the 20-year period of their study.[5] Every one of those jobs created by each of those small businesses was a gain to the communities where they are located and to the broader regions from where they drew employees and to whom they provided goods and services.

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[4] SBA FY18 Agency Financial Report at 9 < https://www.sba.gov/sites/default/files/aboutsbaarticle/SBA_FY_2018_AFR.pdf>. According to the most recent SBIC Program Overview prepared by the SBA's Office of Investment and Information, as of June 30, 2018, nearly 20 percent of those small businesses supported by the 300 SBIC licensed funds were in low- and moderate-income areas.

[5] Paglia and Robinson, Measuring the Role of the SBIC Program in Small Business Job Creation, Report for the Library of Congress, at 4 (January 2017) <https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf>.

Those documented SBIC results are exactly the types of benefits envisioned by Congress in its OZ program.

Lessons Learned

The SBIA commends Congress and the Administration for their successful collaboration that brought the OZ program into existence. As the OZ program launches, SBIA offers the following lessons learned from the SBIC program that may inform the rulemaking process and help ensure that the OZ program delivers on its intended purposes to spark economic growth and investment in distressed areas.

1. Investments in real property help stimulate economic gains in the short-term, but investments in small business create long-term anchors for jobs, economic growth, and community stability.

The emphasis on tangible property investment in the OZ program is significant because of the need in designated opportunity zones to improve housing stock and return unused commercial and industrial properties to the tax base. But investments in tangible property are only part of the equation necessary to realize long-term economic and social benefits for a community. Small business investment is equally critical to the success of these areas.

SBICs invest private capital into meritorious small businesses to finance their operations, and for growth, expansion and modernization of both tangible and intangible property. SBICs have deployed more than $80 billion in capital into more than 172,000 investments during the 60-year history of the program.[6] SBICs are prohibited from doing project financing because SBICs are specifically designed to create permanent jobs and ongoing economic opportunity and not just short-term stimulus. The benefits of SBICs are meant to last long after the SBIC investment is made. This is consistent with the true meaning of community investment.

SBIA recommends a broader definition of "qualified opportunity zone business property" to include intangible property because the active conduct of certain QOZ businesses will, no doubt, involve intangible product. Please consider expanding the "substantially all" test (70 percent/total tangible property) to include investments in both tangible and intangible property provided the intangible property relates back to the tangible property of a QOZB.[7] Treasury regulations should expressly permit QOF investments in entities defined as small businesses under the Small Business Investment Act of 1958 as amended, because this would help ensure that domestic small businesses benefit from the OZ program.[8]

Investments in real property will offer initial economic gains, but investment in small businesses help create anchors for jobs, economic growth and community stability.

2. Screening practices sufficient to weed out bad actors should help mitigate risk of OZ program abuses.

The proposed regulations permit any taxpayer that is a qualifying corporation or partnership for tax purposes to self-certify as a QOF.[9] SBIA acknowledges the need to stand up the OZ program quickly but urges caution here because careful screening of asset manager capacity and integrity will help mitigate risk and program abuse.

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[6] Paglia and Robinson at 4.
[7] See IRS REG-115420-18 at 5.
[8] 15 U.S.C. 662 (5) (*smaller-business concern*) and (12) (*smaller enterprise*).
[9] IRS REG-115420-18 at 19.

The SBIC licensure procedures are instructive. The SBA reviews and approves a prospective SBIC's management team based on professional capabilities and character. Specific criteria include but are not limited to: (i) at least two (2) principals with substantive and analogous principal investment experience; (ii) realized track record of success and superior returns, based on an overall evaluation of appropriate quantitative performance measures; (iii) evidence of a strong rate of deal flow in the investment area proposed for the new fund; (iv) a complementary management team that works well together; (v) managerial, operational, or technical experience that adds value at the portfolio company level; and (vi) a demonstrated ability to manage cash flows.[10]

Careful evaluations conducted on the front end should help limit risks from subsequent program abuse.

3. Investment success in small businesses requires time and nimbleness in capital deployment because each small business is unique.

The draft regulations propose swift timelines for QOF investments by taxpayers necessary to qualify for preferred tax treatment. The OZ program requires eligible taxpayers that want to defer federal tax on realized capital gains to invest those gains in an eligible QOF within 180 days of realization. The timelines may be reasonable for a QOF strategy to invest in tangible assets like real estate, but not necessarily for investors in small and medium-sized businesses where the unique characteristics, risk, and opportunities of each business require due diligence and other demands that may not respect hard deadlines imposed by federal regulation.

SBIA supports the intent of the proposed safe harbors for working capital and intangible property in the draft regulations because they recognize, to a degree, that successful investments in small businesses will require regulatory flexibility.[11] The contours of these safe harbors, moreover, adhere broadly to congressional intent that QOFs themselves need a "reasonable period of time to reinvest" earnings from qualified opportunity zone stocks, partnership interests and sales proceeds from QOZP, which would all qualify as intangible property.[12]

Additional regulatory flexibility may be necessary should investors in SBICs pursue QOFs because SBICs face tighter statutory and regulatory limitations on their investments. Those limitations include, for instance, a prohibition against permanent control over any small business within an SBICs portfolio, limits on the percentage of regulatory capital invested in any one business, and prohibitions on real estate investment.[13]

SBIA encourages the Department to expand the concept of "working capital" in the draft regulations beyond the acquisition, construction or rehabilitation of tangible business property to the development of business operations in an opportunity zone, which represent intangible property.[14] SBIA also urges a broad interpretation of "substantially consistent" as applied under the safe harbor for intangible property because this acknowledges its unique nature as property with value but without a physical existence.[15]

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[10] SBA, "For SBIC Applicants: Phase I, Initial Review," at https://www.sba.gov/partners/sbics/apply-be-sbic#section-header-8.
[11] See IRS REG-115420-18 at 67-68.
[12] 26 U.S.C. 1400Z-2(e)(4)(B).
[13] Regarding questions of corporate control, SBICs may not exercise control beyond seven years over a portfolio company, which is less than the 10-year holding period required under the OZ program for taxpayers to achieve maximum capital gains relief, although this deadline may be extended to complete divestiture of control or to ensure the financial stability of the company, but only subject to written permission by the SBA. 13 C.F.R. §107.865.
[14] See IRS REG-115420-18 at 23-24.
[15] Id. ("(vi) Safe Harbor for use of intangible property. Solely for purposes of applying the use requirement in section 1397C(b)(4) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), the use

Finally, SBIA invites the Department to evaluate if, by paralleling the successful business plans followed by most SBICs today, the net benefits from expanding financing authority for QOFs to make loans to QOZBs and use debt instruments like warrants, which could be treated as if exercised and therefore considered an eligible equity investment, might accelerate OZ success stories.

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SBIA appreciates the opportunity to discuss these issues and looks forward to the opportunity to work together to update applicable regulations for the OZ program to ensure America's small businesses and the communities served have access to the capital they need.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance

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requirement is treated as being satisfied during any period in which the business is proceeding in a manner that is *substantially consistent* with paragraphs (d)(5)(iv)(A) through (C) of this section.") (*emphasis added*).