THINKING ABOUT CONVERTING TO A RIC? IMPORTANT CONSIDERATIONS

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Background

- Various types of private funds may seek to convert to a mutual fund, a closed-end fund, business development company, or an exchange-traded fund taxed as a Regulated Investment Company (“RIC”) under the Internal Revenue Code.

- Other entities that also may seek to convert to a RIC status include:
  - Separate accounts
  - Group trusts
  - Common trust funds

Section 351 Issues

- Section 351(a) provides that “[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation..”

Section 351 Issues

- A contribution in-kind to a corporation incident to its formation (or at a later date if the 80% control test is met) is tax-free (meaning the contributing shareholder recognizes no gain or loss and the fund takes a carryover basis and holding period in the contributed security) if each person contributing securities in-kind transfers in a diversified portfolio of securities.

Section 351 Issues

- Plan of Transfer
  - Transfers should occur pursuant to a “plan of transfer” so as to link together all such transfers in-kind as part of the same plan.
  - Establishing the control group.

Section 351 Issues

- Special rule for investment companies
  - Section 351(e)(1) provides, in part, that “[t]his section shall not apply to— A transfer of property to an investment company…”

Section 351 Issues

- Special rule for investment companies
  - Under Treasury Regulations Section Regulation Section 1.351-1(c)(1), a transfer of property will be considered to be a transfer to an "investment company" if—
    - The transfer results, directly or indirectly, in **diversification of the transferors' interests**, and
    - **The transferee is (a) a regulated investment company**, (b) a real estate investment trust, or (c) a corporation ("80-percent corporation") more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. However, by subsequent statute, the determination of whether a given transferee is an 80-percent corporation now takes into account all stock and securities (and not merely those that are readily marketable) and further defines "stock and securities" to encompass a broad range of assets, including (among other things) money, foreign currency, and certain precious metals.

Section 351 Issues

- Special rule for investment companies

  - One transferor or transfer of identical assets

    - If there is only one transferor (or two or more transferors of identical assets) **to a newly organized corporation**, the transfer will generally be treated as not resulting in diversification. Treasury Regulation Section 1.351-1(c)(5).

Section 351 Issues

- Special rule for investment companies
  - Transfer of non-identical assets
    - A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. Treasury Regulations Section 1.351-1(c)(5).

Section 351 Issues

- Special rule for investment companies
  - 1% De minimis rule
    - If any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. Treasury Regulations Section Regulation Section 1.351-1(c)(5).
      - Based on an example in the regulations, “insignificant” means 1% or less:
        - Example (1). Individuals A, B, and C organize a corporation with 101 shares of common stock. A and B each transfers to it $10,000 worth of the only class of stock of corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. C transfers $200 worth of readily marketable securities in corporation Y for one share of stock. In determining whether or not diversification has occurred, C's participation in the transaction will be disregarded. There is, therefore, no diversification, and gain or loss will not be recognized.

Section 351 Issues

- Special rule for investment companies
  - Plan to achieve diversification
    - If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

Section 351 Issues

- Special rule for investment companies
  - Diversification testing – investment companies
    - Transfer of a diversified portfolio:
      - A transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities.
        - A portfolio of stocks and securities will be treated as diversified if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). Treasury Regulation Section 1.351-1(c)(6)(i).

Section 351 Issues

- Special rule for investment companies
  - Diversification testing – investment companies
    - Two prong test:
      - A corporation meets the requirements of this clause if: (A) not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer, <u>and</u> (B) not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers. Section 368(a)(2)(F).

Section 351 Issues

- Special rule for investment companies
  - Diversification testing – investment companies
    - Controlled group rule: All members of a controlled group of corporations (within the meaning of section 1563(a)) are treated as one issuer.
    - Exclude cash from total assets: In determining total assets cash and cash items (including receivables) are excluded.
    - Government securities: Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests.
    - Securities: The term "securities" includes obligations of State and local governments, commodity futures contracts, shares of RICs and REITs, and other investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)).

Tax Consequences to Partners on Liquidation of the Private Fund

- Generally, liquidating distributions of a partnership do not result in gain or loss to the partners unless the partners receive “**money**” in excess of their basis.
- Section 731(c) treats distributions of “marketable securities” as “money”.
- Under Section 731(c)(2)(B)(i)(II) RIC shares are generally treated as “marketable securities”.

Private Fund Liquidation Issues

- RIC shares will not treated as a distribution of "marketable securities" to a partner if:
  - The partners are "eligible partners" (i.e. they only contributed property that an "investment partnership" can hold)
  - The liquidating partnership is an "**investment partnership**", and
  - The partners only receive RIC stock and no other money.

Private Fund Liquidation Issues

- Section 731(c)(3)(C)(i) defines an "**Investment Partnership"** as:
  - any partnership which has never been engaged in a trade or business and substantially all the assets of which have **<u>always</u>** consisted of:
    - (i) stock in a corporation;
    - (ii) notes, bonds, debentures, or other evidences of indebtedness;
    - (iii) various other financial instruments; or
    - (iv) any combination of the foregoing.

Private Fund Liquidation Issues

- In Master-Feeder contexts: you have to look through lower-tier “investment partnerships” to satisfy the asset holding requirement of section 731(c)(3)(C)(i) if the upper tier investment partnership:
  - (1) actively and substantially participated in the management of the lower-tier partnership, and
  - (2) owned at least 20% of the total profits and capital interests in the lower tier partnership.

ERISA Accounts

- ERISA assets cannot be transferred on an in-kind basis without a Department of Labor exemption.

  - Possible solution: convert these assets to cash and contribute the cash.

Subscription Agreement

- Each Holder will need to complete subscription documents for the fund prior to the date of transfer.

Custodian

- Depending on who acts as the present custodian for the securities transferred or if there are multiple custodians involved, the in-kind transfers can be a time-consuming task for the custodians.

  - Lead time may be required.

Carryover Basis and Holding Period to Fund

- The fund will have a carryover basis and carryover holding period in the assets transferred.

  - Information will need to be supplied.

    - Section 362(a) provides that “[i]f property was acquired on or after June 22, 1954, by a corporation— (1) in connection with a transaction to which Section 351 (relating to transfer of property to corporation controlled by transferor) applies, or (2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.” Under Section 1223(2), a corporation’s holding period includes the holding period of the asset in the hands of the contributing shareholder.

Built-in Gain Rules

- Treasury Regulation Section 1.337(d)-7: Tax on property owned by a C corporation that becomes property of a RIC or REIT.
  - If property owned by a “C corporation” becomes the property of a RIC or REIT (the “converted property”) in a “conversion transaction,” then Section 1374 treatment will apply… unless the C corporation elects deemed sale treatment with respect to the conversion transaction.
    - Disclosure issue for RIC if subject to Section 1374 built-in gain tax.

Built-in Gain Rules

- C corporation:
  - Defined by reference to Section 1361(a)(2).
    - Generally, a corporation that is not an S corporation.
  - Does not include a RIC or REIT for purposes of Treasury Regulation Section 1.337(d)-7.

Built-in Gain Rules

- Conversion transaction
  - The qualification of a C corporation as a RIC or a REIT.
  - The transfer of property owned by a C corporation to a RIC or REIT.

Built-in Gain Rules

- Tax at the RIC level
  - If property owned by a C corporation becomes property of a RIC
    - Then the RIC is subject to tax on the net built-in gain in the converted property under the rules of Section 1374 (subject to certain modifications).

Built-in Gain Rules

- Application to partnerships

  - The rules apply to property transferred by a partnership to a RIC to the extent of any gain or loss in the converted property that would be allocated directly or indirectly through one or more partnerships, to a C corporation if the partnership sold the converted property to an unrelated party at FMV.

Built-in Gain Rules

- Election of deemed sale treatment
  - The application of the built-in gain tax at the RIC level is called off if the C corporation that qualifies as a RIC or transfers property to a RIC makes a deemed sale election.
    - The regulations permit the partnership to make the deemed sale election.

Built-in Gain Rules

- Election of deemed sale treatment
  - C corporation making deemed sale election recognizes gain and loss as if it sold the converted property to an unrelated party at FMV.
    - If the partnership elects deemed sale treatment, then any net gain recognized by the partnership on the deemed sale must be allocated to the C corporation partner.
      - The gain does not increase the capital account of any partner.

Built-in Gain Rules

- Basis adjustment

  - If a deemed sale election is made and the corporation recognizes a net gain, then converted property has a basis to RIC equal to FMV.

    - If the partnership elects deemed sale treatment, then the C corporation partner increases its basis in the RIC stock by the amount of the net gain.

Built-in Gain Rules

- Making the deemed sale election
  - Election is made by including the following statement in the tax return for the C corporation or partnership for the taxable year in which the deemed sale occurs:
    - [Insert name and EIN of electing corporation or partnership] elects deemed sale treatment under Treasury Regulation Section 1.337(d)-7(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT [insert name and EIN of RIC or REIT].
      - The election is irrevocable.

Built-In Loss Rules

- Section 362(e) is an **exception** to the basic rule that the basis of property received by a corporation (such as a RIC) in certain tax-free transactions (including Section 351 exchanges) is identical to the basis of the property in the hands of the transferor (such as the converting partnership) adjusted to include any gain recognized by the transferor in connection with the transfer.

Built-In Loss Rules

- Section 362(e)**<u>(1)</u>** limits the <u>importation</u> of built-in losses.
  - Applies to transfer of foreign-used property to a U.S. corporation (e.g. foreign hedge fund converting to a RIC) with an aggregate <u>net built-in loss</u>.
  - Also applies to property with a net built in loss and held by a tax-exempt entity and transferred to a RIC.

Built-In Loss Rules

- The carryover basis (i.e. the transferee RIC's basis) of **all** the transferred **importation** property is marked-to-market if three conditions exist:
  - 1) Transferor is not subject to U.S. tax on disposition of the property prior to the transfer,
  - 2) The property is subject to U.S. tax if the transferee disposes of it, and
  - 3) The transferees' basis in the property immediately after the transfer exceeds the aggregate FMV of the property transferred.
- Practical implication: importation property with built-in gain must be marked up and built-in loss importation property must be marked down.

Built-In Loss Rules

- Application to a partnership (Prop. Reg. §1.362-3(f) Example 5):

- **Facts**: A and F are equal partners in P. P owns Asset 1 (basis $100, value $70). Under the terms of the P partnership agreement, P's items of income, gain, deduction, and loss are allocated equally between A and F. P transfers Asset 1 to RIC in a transfer to which section 351 applies.

Built-In Loss Rules

- Application to a partnership (Prop. Reg. §1.362-3(f) Example 5) - continued:

- But for 362(e)(1), F's basis in the importation property would be $50, which exceeds the $35 FMV of Asset 1.
- RIC's basis would **initially** be $**85** (A's $50 + F's $35) in the property; exceeding the $70 FMV (i.e., $15 BIL).
- But that is not the end of the inquiry:
- Due to 362(e)**(2)**: RIC's basis in Asset 1 is $70; Pursuant to section 358; P's basis in RIC stock received is still $100.

Built-In Loss Rules

- Section 362(e)**(2)** - Limitation on **Duplication** of Built-in Losses
  - Applies to transfer of all property with a built-in loss to a corporation (e.g. hedge fund converting to a RIC).
  - The carryover basis (i.e. the transferee RIC's basis) of **the loss properties** that are transferred property are marked-to-market if three conditions exist:
    - 1) The property is transferred in a Section 351 transaction,
    - 2) Only applies to the extent that section 362(e)(1) does not apply, and
    - 3) The aggregated adjusted bases of the property transferred exceeds the aggregate FMV.

Built-In Loss Rules

- Practical points: the Section 362(e)(2) adjustment is made on asset-by-asset basis for the loss properties (i.e., you cannot mark the built-in gain properties).
- Practical Tip: Consider selling the property prior to the transfer to recognize the built-in losses.

Built-In Loss Rules

- Section 362(e)(2)(C) Election – There is an irrevocable Joint Election that reduces the basis of the RIC stock transferred that equals the built-in loss in the transferred property received by the RIC.
  - The basis adjustment on RIC stock received by a transferor Partnership is an expenditure under Section 705(a)(2)(B).
  - Why would a RIC ever make a 362(e)(2)(C) election (they generally do not receive depreciable property)?
  - Any need for a RIC to file a protective 362(e)(2)(C) election?

Customary Representations & Opinion

- A Tax Opinion is usually a short-form opinion similar to a RIC-RIC merger, which is:
  - Based upon customary representations and the Reorganization Agreement.
  - Generally provided to the RIC to ensure that it is able to track its basis going forward.
  - Rarely is an opinion provided to the transferor partnership.

Customary Representations & Opinion

- The Tax Opinion will usually provide that:
  - Transferee RIC recognizes no gain or loss on receipt of the assets and upon issuing its stock as consideration
  - Transferee RIC's basis in the assets received equals the basis of the transferor immediately prior to the transfer.
  - Transferee RIC's holding period in the assets received equals the Transferor P's holding period in the assets.

Customary Representations & Opinion

- The Customary Representations:
  - Focus on ensuring there are no side agreements (e.g. loans) other than the contribution of assets and assumption of liabilities in exchange for RIC shares.
  - Require each party to pay their own expenses for the conversion.
  - Demonstrates that there is no plan to dispose of the exchanged assets or the RIC shares and that the RIC will continue on subsequent to the conversion.
  - Establish the control group of transferors and often requires a shell RIC transferee.

Customary Representations & Opinion

- The Customary Representations also:
  - Establish that the transferred assets are diversified under Section 368(a)(2)(F).
  - Prohibit the transfer of partnership interests.
  - Address built-in gain/losses in the transferred assets.
  - Address complexities raised by ‘C’ corporation partners of the converting Fund.

SEC Filings

- Fund is new registrant
  - Initial Form N-1A process applies.
  - Assuming DST, file certificate of trust.
    - Organizational documents: agreement and declaration of trust and bylaws.
    - Establish board.
    - Establish compliance program.
    - Selection of service providers and negotiation of service provider agreements.

SEC Filings

- Fund is new series of existing registrant
  - Register shares of shell fund by filing Form N-1A.
    - 75 day SEC review period versus no set timetable for SEC review for a new registrant.

Approvals

- Partnership: dictated by the partnership agreement.
  - Typically, GP approval only.
    - No N-14 filings such as in the case of a merger of RICs.

Porting Performance

- Three options:
  - Adopt the performance of the private fund.
    - Based on standards set forth in SEC no action letters.
      - Appears in fund summary section of prospectus.
        - Accompanied by disclosure: “Performance for periods prior to January 1, 2016 reflects the performance of the predecessor fund.”
  - Report related performance.
    - Also based on standards set forth in SEC no action letters.
      - Not adopting performance of the private fund.
      - Presented as related performance information in the back of prospectus.
        - FINRA rules more restrictive: only permitted to report related performance in sales literature presented to institutional investors – not in sales literature presented to retail investors.
  - Report performance of new mutual fund from inception.
    - Adopting prior performance of private fund and reporting related performance is not required and is closely scrutinized when new fund choses one of these options.

Porting Performance

- To adopt the performance of a private fund, a new RIC should consider SEC Staff guidance from a 1995 No-Action Letter which generally requires:
  - Same portfolio before & after the conversion
  - Same investment adviser
  - Same investment objectives, policies, etc.
  - Prior fund was not formed to establish a performance history
  - Full disclosure regarding the fact that a prior unregistered fund's history is included in the prospectus.

Conversions Of Other Entities – Common Trusts

- Common trust fund: a fund formed and operated for the investment of assets on behalf of trusts managed by a bank in its fiduciary capacity.

  - Not a corporation; not subject to tax. Section 584(b).

Conversions Of Other Entities – Common Trusts

- Conversion of common trust fund into one or more RICs can be achieved on a tax-free basis (no gain or loss to fund or participants). Section 584(h).
  - Must satisfy the diversification standard applicable to investment company reorganizations – see above for the 25- and 50-percent tests.
  - Must transfer “substantially all its assets” to one or more RICs solely in exchange for RIC stock.
  - Common trust fund then distributes RIC stock to common trust fund participants in exchange for their trust interests.
- Carryover basis to RIC and to common trust fund participants.

Conversions Of Other Entities – Group Trusts

- Group Trusts are a collection of pension trusts and are exempt from tax under Section 501.
- The conversion to a RIC is generally done to include additional types of investors.
- The exchange is generally tax free pursuant to Section 351 because the Group Trust's assets are diversified.
- Practical Tip: It may make sense to structure the transaction as a taxable transaction if taxable investors will enter the new RIC and if the transferred portfolio has built-in gain that would be transferred to the new taxable investors.

Other RIC Tax Issues to Consider from Conversions

- Will the assets the transferred to the RIC produce qualifying income?
  - If not, can you transfer the assets to a CFC on a tax-efficient basis?
  - Will the transfer to a CFC affect the tax profile of the product?
- The RIC’s carryover basis will affect its future distribution requirement.