

TAXATION OF REGULATED INVESTMENT COMPANIES

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I. In General

A. Economic functions

1. Pooling of investments
2. Investment diversity
3. Investment advice and management

2. General operation

1. These entities are intended to be vehicles for holding passive investments.
2. It is intended that the entities pass-through most of their income to shareholders.
3. If requirements designed to achieve these goals are satisfied, then the entity qualifies for special tax treatment that eliminates the burden of double taxation.

II. Taxation of Regulated Investment Companies

A. Qualification as a RIC

1. Eligible entities

- a. Section 851(a) defines the types of domestic corporations that can elect to be taxed as a RIC. See Treas. Reg. § 1.851-1.
- b. A RIC must be a corporation either (1) registered with the SEC under the Investment Company Act of 1940 as a management company or as a unit investment trust, or (2) that has elected to be treated as a business development company. Section 851(a)(1).
- c. Also, a RIC may be a common trust fund that is not within the definition of section 584(a). Section 851(a)(2).
- d. The 1984 Act removed the prohibition against personal holding companies (PHCS) qualifying for RIC status. See Rev. Rul. 88-41, 1988-1 C.B. 253.
- e. Each series fund established by a RIC will be treated as a separate corporation and must separately meet all of the RIC qualification requirements. Section 851(g).
- f. A RIC may have more than one class of shares, but no class may receive preferential dividend distributions. Rev. Rul. 89-81, 1989-1 C.B. 226.

2. Election of RIC status
 - a. An eligible corporation must elect to be taxed as a RIC. Section 851(b)(1).
 - b. To be able to make the election, the corporation must have been taxed as a RIC for all tax years ending on or after November 8, 1983 (Section 852(a)(2)(A)), or have no earnings and profits from any year in which it was not taxed as a RIC (Section 852(a)(2)(B)).
 - (1) A corporation can make distributions out of accumulated earnings and profits in order to comply with section 852(a)(2)(B). Section 852(c)(3).
 - (2) If an entity loses its RIC status, it can distribute non-RIC earnings and profits in order to requalify. Section 852(e).
3. Source of income requirement
 - a. At least 90 percent of the corporations gross income must be from dividends, interest, payments with respect to securities loans, gains from the sale of stock or securities, or foreign currencies, or other income.¹ Section 851(b)(2).
 - (1) The 1986 Act expanded the allowable categories of gross income to include certain foreign currency gains.
 - (2) The Treasury is authorized to issue regulations excluding foreign currency gains not directly related to the RIC's principal investing business.

¹ For tax years prior to 1998, there were two income requirements, both of which were intended to ensure that the RIC primarily receives passive investment income. For years after 1997, only one requirement applies (the 90 percent test).

For pre-1998 years, it also was required that less than 30 percent of the corporation's gross income must be from the sale of certain types of investments held for less than three months, including stock or securities, options, futures, forward contracts, and foreign currencies not directly related to the RIC's principal investing business. Pre-1997 Act section 851(b)(3).

Pre-1997 Act section 851 (g) (enacted in the 1986 Act) provided a special rule applicable when a RIC hedges its investments and special rules for abnormal redemptions by funds that belong to a series fund.

In 1997, the 30 percent test was repealed by the Taxpayer Relief Act of 1997 for tax years beginning after August 5, 1997. See P.L. 105-34, section 1271.

- (3) Income from a partnership or trust is includible only if it would be includible had the RIC received the income directly.
 - (4) Reimbursements received from the RIC's investment advisor may constitute qualifying income. Rev. Rul. 92-56, 1992-2 C.B. 153.
 - (5) For tax years beginning after October 22, 2004, qualifying income also includes income and gains from qualified publicly traded partnerships ("qualified PTPs"). Section 851(b)(2)(B), as amended by section 331 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 ("2004 Jobs Act").
 - (a) A "PTP" is any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).
 - (b) A "qualified PTP" includes a PTP as defined in section 7704(b), other than a partnership that derives 90% or more of its income from interest, dividends, capital gains, and other sources of traditional qualifying RIC sources of income. Section 851(h). Note that a qualified PTP may invest in any type of business, e.g., oil and gas.
- b. For purposes of the 90-percent test:
 - (1) capital losses are ignored, and
 - (2) tax-exempt interest is included in income.
 - c. See Example #10
 - d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325)² provides an exception for failure to satisfy the source income test.
 - (1) A corporation that fails to meet the source income test for any taxable year is considered to satisfy to satisfy the requirement if:

² The provision enacted by the Regulated Investment Company Modernization Act of 2010 are generally effective for tax years beginning after 12-22-2010.

- (a) Following the RIC's identification of the failure, a description of each item of its gross income that satisfies the source income test is provided to the Secretary, and
 - (b) Failure to meet such requirement is due to reasonable cause and not due to willful neglect. Section 851(i)(1)
 - (2) In addition, there is a tax in an amount equal to the excess of (A) the gross income of such company which is not derived from sources satisfying the source income test over (B) 1/9 of the gross income of such company which is derived from such sources. Section 851(i)(2).
- 4. Investment diversification requirements
 - a. There are two investment requirements, both of which must be met at the close of each quarter.
 - b. First, at least 50 percent of the corporation's assets must be invested in cash, government securities, RIC securities, and certain other types of securities. Section 851(b)(3)(A).
 - (1) "Government securities" include Treasury securities, as well as Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), Student Loan Marketing Association (SLMA), Federal Home Loan Bank (FHLB) and Federal Home Loan Mortgage Corporation (FHLMC) obligations, as well as certain investments in refunded bonds. Rev. Rul. 2003-84, 2003-32 I.R.B. 289; Rev. Rul. 92-89, 1992-2 C.B. 154; GCM 39626 (Apr. 29, 1987); LTR 8806044 (Nov. 17, 1987); LTR 9006015 (Nov. 8, 1989); LTR 9015011 (Jan. 8, 1990). A RIC's investment in a "repo" transaction involving a government security qualifies as an investment in the government security itself, as long as the repo is "fully collateralized" as defined by Securities and Exchange Commission Rule 5b-3 (effective for repos held by a RIC as investments on or after August 15, 2001). Rev. Proc. 2004-28, 2004-22 I.R.B. 984.
 - (2) The RIC can be treated as directly owning the assets held by certain partnerships. Rev. Proc. 2005-20.
 - (3) For purposes of the 50-percent test, a RIC may not count securities of any (non-RIC, non-government) issuer if:

- (a) the value of those securities exceeds 5 percent of the value of the RIC's assets, or
 - (b) the securities exceed 10 percent of the issuer's outstanding voting securities (including equity securities of a qualified PTP for tax years beginning after October 22, 2004). Section 851(b)(3)(A); section 851(c)(5).
- (4) If the 50-percent test is met, the RIC's other investments need not be diversified.
- (5) See Example #11.
- (6) There is an exception to the 50-percent test applicable to certain RICs that are certified by the SEC as principally engaged in furnishing venture capital to corporations engaged in inventing or developing new products or processes, etc. Section 851(e).
 - (a) In the 50-percent test, the RIC may include stock even if it holds more than 10 percent of the stock of the issuer. (However, this exception does not apply if the RIC has held the stock for 10 or more years.)
 - (b) In the 50-percent test, the 5-percent limit also is modified. A RIC may hold stock the cost (rather than value) of which is 5 percent of the value of the RIC's assets as of the date of the last acquisition of the stock of that issuer.
 - (c) See Example #12.
- c. Second, no more than 25 percent of the value of the RIC's total assets may be invested in securities (other than government or other RIC securities) of one issuer, or of two or more issuers (1) of which the RIC owns 20 percent or more, and (2) which are in similar or related businesses. Section 851(b)(3)(B). For tax years beginning after October 22, 2004, this includes securities of qualified PTPs. Section 851(b)(3)(B).
 - (1) This test counts both stock held directly by the RIC, and the proper proportion of stock held by corporations at least 20-percent owned by the RIC. Section 851(c).
 - (2) See Example #13.

- d. The two investment diversification tests must be satisfied quarterly. If a RIC satisfies the tests for one quarter, and then, due solely to fluctuations in market value, fails to meet one of the tests in the next quarter, it retains RIC status. Section 851(d)(1).
- e. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) provides special rules regarding failure to satisfy the two investment diversification tests provided the exception in section 851(d)(1) does not apply.

(1) Reasonable Cause: A RIC that fails to meet the investment diversification tests is considered to satisfy the tests for such quarter if (i) a description of the asset causing the failure is filed in the manner provided by the Secretary, (ii) the failure is due to reasonable cause and not due to willful neglect, and (iii) the RIC disposes of the assets causing the failure or the requirements are otherwise met within 6 months after the last day of the quarter in which the RIC identified the failure. Section 851(d)(2)(A).

(a) If the reasonable cause exception applies for any quarter, a tax is imposed on the RIC equal to the greater of (I) \$50,000, or (II) the amount determined by multiplying the net income generated by the assets causing the RIC to fail the investment diversification test for the relevant period times the highest rate of tax in Section 11. Section 851(d)(2)(C)(i).

(b) The relevant period is the period beginning on the first date that the failure to satisfy the investment diversification test occurs as a result of the ownership of such assets and ending on the earlier of the date on which the corporation disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy the investment diversification requirements. Section 851(d)(2)(C)(ii).

(2) De Minimis: A RIC that fails to meet the investment diversification tests is considered to satisfy the tests for such quarter if (i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of (I) 1% of the total value of the corporation's assets at the end of the quarter, or (II) \$10,000,000, and (ii) the RIC disposes of the assets causing the failure or the requirements are otherwise met within 6 months after the

last day of the quarter in which the RIC identified the failure. Section 851(d)(2)(B).

- f. RIC status will not be lost if a distribution to shareholders causes it to fail one of the tests. Treas. Reg. § 1.851-5, Example (5).
 - g. However, if a RIC fails one of the tests due to the acquisition of new assets, then RIC status will be lost, unless assets are disposed of and the tests are satisfied within 30 days of the close of the quarter in which the tests are failed. Section 851(d)(1).
 - h. In response to the financial systems affecting the banking system and the financial markets in 2009, the government established the Troubled Asset Relief Program (TARP). One of the TARP programs partners the government with private investors to form Public-Private Investment Partnerships (“PPIP”). For purposes of the two investment requirements (section 851(b)(3)), the RIC will be treated as if it directly invested in assets held by the PPIP in which it invests provided that (1) the RIC invests, as a partner, at least 70% of its original assets in one or more PPIPs, and (2) the PPIP is treated as a partnership for federal tax purposes. For these purposes, the RIC’s interest in PPIP assets is determined in accordance with its percentage of ownership of the capital interests in the PPIP. Rev. Proc. 2009-42.
5. A RIC holding an interest in a partnership other than a qualified PTP is deemed to hold a proportionate part of the partnership’s assets, and to receive a proportionate part of the partnership’s income for purposes of the asset and income qualification requirements. LTR 9332031 (May 17, 1993).
6. Distribution requirements
- a. For each year, the RIC must distribute an aggregate amount, ignoring capital gains, that equals or exceeds the sum of (section 852(a)(1)):
 - (1) 90 percent of its gross “investment company taxable income,” plus
 - (2) 90 percent of the excess of its tax-exempt interest income over expenses allocable thereto.
 - b. The amounts distributed must qualify under the section 243 DRD provisions. The distribution may not qualify for the DRD if it is a preferential dividend. Rev. Rul. 89-81, 19891 C.B. 226.

- c. These distribution requirements may be waived if the RIC is unable to comply due to prior distributions made to avoid imposition of the section 4982 excise tax.
- d. In order to meet these requirements, a RIC may elect to treat certain dividends paid after the close of a taxable year as paid during the taxable year.
 - (1) Section 852(b)(7) provides that dividends declared and payable to shareholders of record on a date during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year.
 - (2) Section 855(a) provides that if a RIC declares a dividend and distributes the dividend within 12 months of year end (but not later than its first regular dividend payment), the RIC may elect in the return to treat the dividend as paid for the year covered by the return. For distributions in tax years beginning on or before 12-22-2010, the RIC must declare the dividend before its return due date. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) revised the rule to provide that for distributions in tax years beginning after 12-22-2010, the RIC must declare a dividend before the later of (A) the 15th day of the 9th month following the close of the taxable year, or (B) in the case of an extension of time for filing the company's return for the taxable year, the due date for filing such return taking into account such extension.
 - (3) Section 860 allows for the deduction of deficiency dividends. The 2004 Jobs Act expanded the definition of a deficiency dividend to include additional amounts required to be paid, as determined by the RIC prior to any controversy with the IRS. New section 860(e)(4).

B. Taxation of RICs

- 1. If a corporation fails to qualify as a RIC, it will be taxed as an ordinary corporation on its entire taxable income (although it can claim the 70-percent section 243 deduction). Distributions of earnings will be taxable as dividends to the extent of current earnings and profits, and thereafter will be applied against shareholders' basis in their shares.
- 2. If the corporation qualifies as a RIC:
 - a. The RIC is taxed on its investment company taxable income ("ICTI"), which is its taxable income, less (i) net capital gain,

(ii) amounts of ordinary, taxable income distributed to shareholders and eligible for the section 561 deduction for dividends paid, (iii) an amount equal to the tax imposed by section 851(d)(2) and (i), and (iv) certain other adjustments. Section 852(b)(1), (2) and (8).

- (1) ICTI thus is comprised of retained, taxable, ordinary income.
- (2) Tax on ICTI is imposed at section 11 rates. If a RIC is a personal holding company, the tax is computed at the highest section 11 rate.
- (3) The deduction for dividends paid may not be allowed if the RIC favors a class of shareholders with preferential dividend distribution treatment. Rev. Rul. 89-81, 1989-1 C.B. 226.
- (4) The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) repeals the preferential dividend rules for publicly offered RICs for taxable years beginning after December 22, 2010. Section 562(c).
- (5) Income or gains from a RIC's interest in a qualified PTP is subject to the passive activity rules of section 469(k)(4). Thus, a RIC can recognize losses from a qualified PTP only to the extent of income or gains from that PTP.

b. The RIC is also taxed on its undistributed net capital gain, (i.e., capital gains less capital gain dividends). Section 852(b)(3). Certain losses incurred after October 31st of the year may be excluded in computing net capital gain for the year. Treas. Reg. § 1.852-11.

c. The RIC is not taxed on its tax-exempt interest. However, in computing ICTI, a prorated amount of expenses are not deductible by RICs that distribute tax-exempt dividends. Section 265(a)(3).

d. The RIC also is subject to an excise tax on undistributed income.

- (1) The amount of the excise tax is 4 percent of the excess of (i) 98 percent of ordinary income for the calendar year, plus 98.2 percent of net capital gain for the year ending October 31, over (ii) the amount distributed. This amount will be increased by amounts not distributed in the preceding year. Section 4982. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) increased the

percent of net capital gain from 98 percent to 98.2 percent effective for calendar years beginning after 12-22-2010.

- (2) The RIC is excepted from the excise tax if it is owned by certain types of taxpayers, including qualified pension trusts. Section 4982(f).

C. Taxation of RIC Shareholders

1. Ordinary Income Dividends

- a. RIC dividends of ordinary income are includible in gross income, to the extent of the RIC's earnings and profits. Treas. Reg. § 1.852-4(a)(1). See section 854(b).

- (1) Special rules for determining RIC earnings and profits are provided. Section 852(c).

- (2) If the RIC has no E&P, the dividends are a non-taxable return of capital, which reduces the basis of the shareholder's shares.

- (3) Section 1(h)(11) provides that "qualified dividend income" is taxed as capital gain instead of ordinary income. Dividends distributed by RICs are "qualified dividend income," but are subject to the limitations of section 854(b).

2. The section 67 rules regarding the two percent floor on miscellaneous itemized deductions are not taken into account at the pass-through entity level, but at the owner level.

- a. However, the two percent floor does not apply to any publicly offered RIC. Section 67(c)(2).

- b. For nonpublicly traded RICs, dividends may be grossed-up to reflect the shareholder's share of investment expenses.

3. Tax-exempt interest dividends

- a. RICs that invest at least 50 percent of the value of their total assets in tax-exempt obligations may distribute tax-exempt dividends. Section 852(b)(5).

- (1) For purposes of this asset test, RICs that hold partnership interests described in Rev. Proc. 2002-68, 2002-43 I.R.B. 753, called "synthetic tax-exempt variable-rate bonds," are

treated as if they directly invested in the assets held by the partnership. Rev. Proc. 2003-32, 2003- 16 I.R.B. 803.

- b. The amount of the tax-exempt dividend equals tax-exempt interest income less expenses allocable thereto.
 - c. Tax-exempt dividends must be so designated by written notice to shareholders.
 - d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) adds new rules permitting the pass-through of tax-exempt dividends to qualified fund of funds. A qualified fund of funds means a RIC at least 50 percent of the value of its total assets is represented by interests in other RICs. Section 852(g).
4. Foreign tax credit
- a. Ordinarily, a RIC is entitled to the same credit or deduction for foreign taxes as any other corporation.
 - b. Under certain conditions, the RIC can transfer that right to its shareholders, and, in effect, the shareholders are treated as directly owning stock in a foreign corporation. Treas. Reg. 1.853-2(b).
 - c. If the company transfers the right, it loses the deduction or credit, but adds the amount of taxes involved in the right so transferred to its dividends paid deduction. Each shareholder of the electing RIC includes in gross income and treats as paid, his or her share of foreign taxes. Section 853(a), (b).
 - d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) adds new rules permitting the pass-through of foreign tax credits to qualified fund of funds. A qualified fund of funds means a RIC at least 50 percent of the value of its total assets is represented by interests in other RICs. Section 852(g).
5. Capital gain dividends
- a. RIC dividends of capital gain are taxable to shareholders as long-term capital gain, regardless of the shareholder's holding period. Section 852(b)(3).
 - b. Capital gain dividends must be so designated by written notice to shareholders.
 - c. Shareholders are taxed on the capital gain dividends at the capital gains rates of section 1(h).

- d. For purposes of computing the maximum tax rate on dividends taxed as capital gain under section 1(h)(11), capital gain dividends distributed by RICs are not treated as dividends. Section 854(a).
6. Undistributed capital gains
- a. Undistributed capital gain also can be reported as taxable to shareholders, as long-term capital gain. Section 852(b)(3)(D).
 - b. The RIC pays a tax on undistributed capital gain. Section 852(b)(3)(A). Shareholders are deemed to have paid that tax. Section 852(b)(3)(D)(ii).
 - c. The shareholder's basis in his RIC shares is increased by the difference between the amount of undistributed capital gain and the tax deemed paid by the shareholder in respect of such shares. Section 852(b)(3)(D)(iii).³
7. Year in which dividends are taxable
- a. Generally, amounts paid to RIC shareholders are taxable to the shareholders in the year received. See also section 855(b).
 - b. If a RIC declares a dividend under the section 852(b)(7) procedure, the dividend will be deemed received on December 31 of the calendar year in which it is declared.
8. Special Rules Applicable to Non-U.S. Investors
- a. The 2004 Jobs Act provides an exemption from U.S. basis tax for certain "interest-related dividends" and "short-term capital gain dividends" paid by a RIC to a non-U.S. person. Sections 871(k)(1)-(2); 881(e)(1)(A)(effective for tax years beginning after December 31, 2004).
 - b. The 2004 Jobs Act extends current law treatment of gain from the exchange of U.S. real property interests by REITs to RICs. Thus, any distribution by a qualified RIC to a foreign person will, to the extent attributable to gain from the sale or exchange of a U.S. real property interest, be treated as gain recognized from the sale or exchange of a U.S. real property interest. Section 897(h)(1).
9. Sales of RIC shares

³ For tax years beginning on or before August 5, 1997, a shareholder's basis is increased by 65 percent of the undistributed capital gain. Pre-1997 Act section 852(b)(3)(D)(iii).

- a. In general, sales of RIC shares are treated like sales of other capital assets.
- b. However, if RIC shares are held for 6 months or less, and then sold at a loss, then the loss (section 852(b)(4)):
 - (1) to the extent that the shareholder has received a capital gain dividend, or has been credited with undistributed capital gain, shall be a long term capital loss.
 - (2) to the extent that the shareholder has received a tax-exempt interest, shall be disallowed.