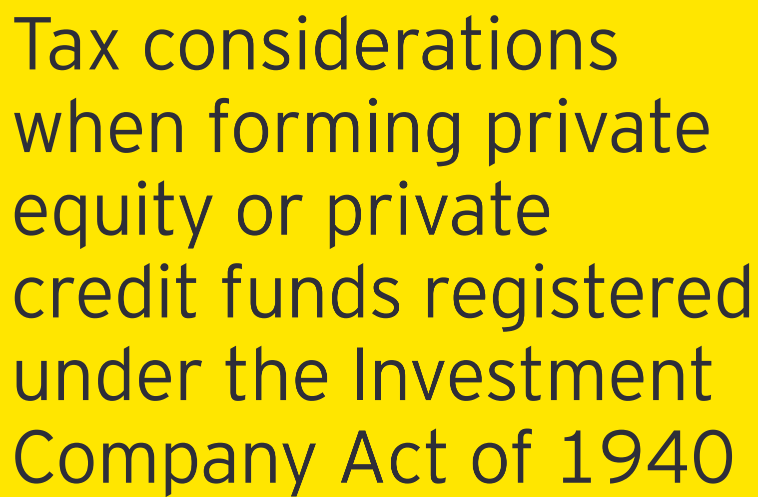

Tax considerations when forming private equity or private credit funds registered under the Investment Company Act of 1940

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Alternative investment strategies, including private equity, private credit, hedge funds, real estate, infrastructure, natural resources and digital assets (generally referred to in the industry as "alts"), have traditionally been offered to ultra-high-net-worth individuals and institutional investors due to high investment minimums and investor suitability requirements. Today, many traditional and alternative asset managers are seeking to make alts investment strategies more accessible to high-net-worth and mass affluent[1] retail investors who are increasingly requesting exposure to these offerings.

In order to reach this retail audience, alts investment strategies are being offered through pooled investment vehicles that are registered under the Investment Company Act of 1940, as amended (the 1940 Act). These structures include registered, closed-end interval and tender offer funds, as well as business development companies (BDCs) (collectively referred to herein as "Alts Funds"). In these 1940 Act "wrappers," investment minimums are generally lower and offer more investor liquidity, less complexity and lower cost than traditional private funds.

As vehicles that are registered under the 1940 Act, they also offer increased transparency and regulatory and board oversight than traditional private funds. These vehicles are generally also structured as regulated investment companies (RICs) for US federal income tax purposes.

We have observed an industry trend of alts and traditional asset managers launching these 1940 Act funds in both the private credit and private equity space. Alternative asset managers, however, may be unfamiliar with the different tax requirements of these products relative to their private funds. Moreover, while traditional asset managers generally may be familiar with the tax requirements applicable to registered funds, there are additional and unique tax considerations and challenges for these Alts Funds relative to more traditional mutual funds and exchange-traded funds (ETFs). This article provides an overview of US federal income tax considerations for asset managers looking to form these Alts Funds, focusing on private credit and private equity Alts Funds.

[1] Mass affluent individuals are generally regarded as having between $100,000 and $1 million in liquid, investable assets. They are one tier below high-net-worth individuals, which are generally regarded as those having over $1 million in investable assets.

Section one

Overview

Before we discuss the tax considerations, this section provides a brief overview of the three different Alts Fund structures and the private credit and private equity investment strategies.

Overview of Alts Fund structures

Most investment companies registered under the 1940 Act are open-end funds, including mutual funds and ETFs. In contrast, the Alts Funds, including BDCs, are each a form of a closed-end fund (CEF). Unlike traditional open-end mutual funds, CEFs are not required to buy back shares from shareholders upon their demand. As a result, CEF managers do not have the same concerns about constant redemptions as open-end fund managers do and thus do not have to manage the possibility of daily shareholder redemptions. As a result, CEFs have flexibility to invest in less liquid assets. Further, traditional CEFs typically sell their shares in an initial public offering, after which their shares trade on a securities exchange at market prices.

Interval funds

Interval funds are a special type of CEF registered under the 1940 Act that continuously or periodically (e.g., monthly) offer their shares at a price based on the CEF's net asset value (NAV). Interval funds' shares may be publicly or privately offered, but they typically do not trade on a securities exchange. Instead, to provide shareholder liquidity, interval funds are required to buy back, or "repurchase," shares directly from shareholders at specific periodic intervals (quarterly, semiannually or annually - most commonly, quarterly). When they do so, they repurchase only a limited percentage of all outstanding shares, generally between 5% and 25%, at the interval fund's then-current NAV. In this respect, interval funds are essentially a hybrid between traditional open-end mutual funds and traditional CEFs.

Tender offer funds

Tender offer funds are CEFs registered under the 1940 Act that may, but, unlike interval funds, are not obligated to, provide periodic liquidity to shareholders through issuer tender offers (typically quarterly) at the discretion of the fund's board of directors. Tender offer funds may be listed on an exchange or unlisted, and their shares may be publicly or privately offered. If unlisted, similar to interval funds, they may engage in a continuous or periodic (e.g., monthly) offering of their shares.

BDCs

BDCs are also a form of CEF, but they are not registered as investment companies under the 1940 Act. Rather, they elect to be BDCs under the 1940 Act. By so electing, they agree to be subject to some of the provisions of the 1940 Act to which registered investment companies are subject, as well as separate BDC-specific requirements designed to ensure that a BDC's primary purpose is to provide loans to, or take minority equity stakes in, small and medium-sized private companies in the US. For instance, a BDC must invest at least 70% of its total assets in "qualifying assets," which, very generally, include private US companies with an equity market capitalization of less than $250 million, cash and government securities. BDCs are also required to offer managerial assistance to their portfolio companies.

BDCs have more flexibility than tender offer and interval funds in terms of issuing classes of debt and the amount of leverage they can maintain. BDCs may be listed on an exchange or unlisted, and their shares may be publicly or privately offered. If unlisted, BDCs may engage in continuous or periodic offerings of their shares and may provide shareholder liquidity by operating as an interval or tender offer fund.

Overview of investment strategies

Private equity

Mutual funds and ETFs seeking equity exposure typically do so through the public equity markets, investing in publicly traded stocks and other equity securities. In contrast, a private equity fund invests in the equity of private companies (i.e., stock or other equity securities in companies that do not have publicly traded shares). Private equity is a broad term that can include several different strategies, including venture capital, growth equity, buyouts, infrastructure, secondaries and funds of private funds. An Alts Fund with a private equity strategy may directly provide equity capital to a private company or invest indirectly in these companies through investments in traditional private equity funds or funds of private equity funds (collectively, "Underlying Private Funds"). Underlying Private Funds are typically structured as partnerships for tax purposes, although, as discussed later, corporate "blockers" are frequently available for certain tax-sensitive investors.

Private credit

Mutual funds and ETFs seeking fixed income exposure typically do so by purchasing bonds and other fixed income securities in the public credit market. In contrast, a growing number of Alts Funds are being offered in the private credit space. This includes Alts Funds (typically BDCs) engaging in direct lending to small-and middle-market private companies. Depending on strategy, an Alts Fund may also buy privately negotiated debt, syndicated loans, or other private debt of small- or middle-market borrowers, or invest in Underlying Private Funds engaging in these activities. Private credit is a broad area that can encompass several different investment strategies, including senior debt, subordinated debt or other capital, distressed credit and specialty finance.

Lenders, including Alts Funds, in this space aim to provide a more customized financial solution than banks to address specific needs of small- or middle-market customers, as well as earn attractive risk-adjusted returns relative to the bond market. In addition, an Alts Fund may receive an "equity kicker" as part of a private credit lending transaction, where the Alts Fund provides a loan at a lower interest rate in exchange for an equity position in the borrower's company. As private equity investments, equity kickers present many of the same tax compliance issues as those described in this article for Alts Funds with private equity strategies.

Tax advantages of RICs for different types of investors

Privately offered Alts Funds are typically partnerships for US federal income tax purposes. In contrast, mutual funds, ETFs and CEFs typically elect to be treated as RICs under Subchapter M of the Internal Revenue Code (the Code). Alts Funds typically also elect to be RICs. As a RIC, an Alts Fund generally does not pay entity-level income taxes if it meets the ongoing RIC qualification and distribution requirements described later. The primary benefits of a RIC structure over a partnership structure include:

- **Simpler for certain types of tax-sensitive investors.** Because a RIC is a corporation, it serves as a "blocker" for different types of income that can be problematic for certain investors (e.g., because it triggers US federal tax filings or imposes additional taxation on an investor). This includes US trade or business income (effectively connected income, or ECI) for foreign investors; unrelated business taxable income (UBTI) for US tax-exempt investors; and foreign, state and local income tax filing requirements for all investors.
- **Some "pass-through" of tax character.** RICs "pass through" certain types of tax-favored income earned on their underlying investments during the year (e.g., qualified dividend income, long-term capital gain, tax-exempt interest). They are able to do this by reporting all or a portion of the character of the dividends they pay during the year as having the applicable tax character.
- **Simplified and timely shareholder tax reporting.** RICs use simplified shareholder tax reporting (Form 1099), which is better suited for retail investors than complex Schedules K-1 provided by partnerships. Further, RICs typically provide their Forms 1099 to investors in the first two months of the calendar year in time for the April 15 tax filing deadline. In contrast, many private funds that are partnerships will not distribute their final Schedules K-1 until much later in the year, requiring investors to file their individual income tax returns on extension.
- **No "phantom income"[2] for investors.** It is common for investors in a private fund that is a partnership to be taxed on phantom income on their investments for which they do not receive a corresponding distribution.[3] In contrast, investors in RICs are taxed on only the dividends paid to them from the RIC during the year.[4]

[2] "Phantom income" refers to income earned by an investor for which no associated cash is received or distributed, but the investor must nevertheless pay taxes on such income.
[3] In some cases, however, funds will make tax distributions to investors to help them pay their tax bill.
[4] This assumes that a RIC investor elects to have its distributions paid in cash. If it elects to have those distributions reinvested in additional shares of the RIC, the investor will still be currently taxed on those distributions despite not receiving the cash.

Alts Funds can require close monitoring and proactive management of their compliance with RIC qualification tests.

Section three

RIC qualification tests

To qualify as a RIC annually, an Alts Fund must:

01
Pass an annual qualifying income test

02
Pass quarterly asset diversification tests

03
Distribute annually at least 90% of its net investment income and short-term capital gain

Operating within the scope of these requirements on an ongoing basis is fairly standard for traditional mutual funds and ETFs investing in a diversified portfolio of publicly traded stocks or bonds. However, ongoing compliance with these requirements can be more difficult for Alts Funds, particularly those with a private equity strategy. Alts Funds can require close monitoring and proactive management of their compliance with RIC qualification tests throughout the year by both front- and back-office personnel, including portfolio management.

If an Alts Fund were to fail to qualify as a RIC for a year and were unable to cure such failure, the Alts Fund would be taxed as a regular corporation for that year, including paying a corporate income tax (21% federal rate) on any net income or gains that year. Under some circumstances, an Alts Fund would also be required to mark to market its assets and pay a corporate income tax on any net built-in gains in order to requalify as a RIC in a future year. In general, qualification failures are unusual among 1940 Act-registered funds; thus, an Alts Fund's failure to qualify can have an adverse impact on the Alts Fund and its investors, and it poses the risk of negative publicity and reputational harm for fund management.

Annual qualifying income test

Basic test

Generally, at least 90% of an Alts Fund's annual gross income must be derived from dividends; interest; gains from the sale or other disposition of stock or securities or foreign currencies; and other income derived with respect to its business of investing in such stock, securities or currencies, as well as net income derived from an interest in a "qualified publicly traded partnership" (QPTP) (e.g., oil and gas master limited partnerships). This test is generally designed to help ensure that a RIC is engaging in passive investment activities and is not functioning as an operating business corporation. Common examples of investments generating nonqualifying income are equity interests in flow-through entities with business operating income, and interests in real property, natural resources or commodities.

Cure provision

If more than 10% of an Alts Fund's gross income is from nonqualifying sources for a particular taxable year, a limited cure may be available to avoid a RIC qualification failure. A RIC is permitted to cure a failure to comply with the gross income test by paying a tax equal to 100% of the amount by which it failed the test. However, this is permitted only if an Alts Fund can establish to the Internal Revenue Service (IRS) that its failure was due to "reasonable cause and not due to willful neglect," which generally means that the RIC exercised ordinary business care and prudence in entering into the transaction that caused the failure; this determination is based on the Alts Fund's specific facts and circumstances.

Qualifying income considerations for private equity investments

An Alts Fund can earn nonqualifying income to the extent that it makes private equity investments in portfolio companies that are partnerships or other flow-through vehicles for tax purposes. There can be multiple tiers of flow-through entities, particularly where a fund invests in Underlying Private Funds. For RIC qualifying income purposes, income derived from a partnership or other flow-through vehicle (or chain thereof) is treated as if earned directly by the RIC. Portfolio companies are typically operating companies that generate active trade or business income, which is not qualifying income for a RIC. Thus, unless a portfolio company is a corporation for tax purposes, its income generally must be blocked by a corporate vehicle (as discussed later in this article) somewhere in the ownership chain between the portfolio company and the investing Alts Fund.

Underlying Private Fund considerations

Pre-investment tax due diligence. Thorough, pre-investment diligence is crucial for an Alts Fund investing in Underlying Private Funds to assess their qualifying income risks. To assess the extent to which an Underlying Private Fund could generate nonqualifying income, prior to an Alts Fund's investment, it is prudent to:

- Review the Underlying Private Fund's offering memorandum, limited partnership or other operating agreement, and other investor documentation
- Discuss with the fund sponsor its intended investments
- Obtain Schedules K-1 and K-3[5] and financial statements for prior years if an Underlying Private Fund is already in operation

Further, if practicable, an Alts Fund should seek to obtain a commitment or undertaking from the fund sponsor (ideally in a side letter) that the Underlying Private Fund will avoid making investments or engaging in activities that could generate RIC nonqualifying income.

The level of required diligence and availability of information needed prior to investment will vary depending on an Underlying Private Fund's investment strategy and structure, as well as whether the Alts Fund is purchasing in the primary or secondary market. For instance, Underlying Private Funds that are co-investment[6] or continuation funds[7] tend to be the easiest types to assess. For instance, a continuation fund may be limited by its terms to investing in only a single, specified portfolio company that itself is a corporation for tax purposes. If so, that Underlying Private Fund generally will not present qualifying income concerns. In contrast, an Alts Fund that is purchasing limited partnership interests in a pool of Underlying Private Funds in the secondary market (secondaries) may have difficulty obtaining a sufficient amount of information about each secondary fund prior to investment, in which case an Alts Fund may need to invest through one or more corporate entities.

[5] See examples in the Appendix.
[6] Co-investments are direct investments in specific private companies or assets or indirect investments in specific private companies or assets through a vehicle managed and controlled by a general partner or sponsor; this is referred to as the "co-investment fund." Co-investments are typically offered to private equity fund investors when the private equity fund sponsor believes that there is an attractive investment for the fund, but the total size of the potential holding exceeds the targeted size or allocation for the fund.
[7] A sponsor may form a "continuation fund" to acquire one or more portfolio company assets of an existing private equity fund (usually one that is close to the end of its term). Investors in the existing fund may be offered the option to sell out of the existing fund or to roll their interests into the new continuation fund to remain invested in the underlying portfolio company assets. New investors are typically given the opportunity to invest in a continuation fund with cash, providing liquidity for existing investors in the existing fund who have elected to sell out.

Investing through corporate entities. If, based on the pre-investment due diligence, it seems likely that nonqualifying income will pass through to the Alts Fund or there is uncertainty as to whether a particular Underlying Private Fund will pass through nonqualifying income, then the Alts Fund should consider investing through a corporate blocker through a corporate blocker entity. See "Use of corporate entities" later in this article.

Permitted transfers. It is important to consider that a determination regarding whether to use a blocker is not only a time-of-investment decision. Rather, circumstances can change over time with a portfolio company or Underlying Private Fund that are not within the control of the Alts Fund. In some cases, these changes can put the Alts Fund at risk of a qualifying income or other RIC qualification failure. Therefore, it is recommended that an Alts Fund "future-proof" its investments by obtaining a side letter or other assurances from the general partner or sponsor that it will notify the Alts Fund in advance of any potentially adverse changes and allow the Alts Fund to transfer its partnership interests into an alternative entity should the Alts Fund determine that it is necessary to avoid a RIC qualification problem.[8]

Ongoing due diligence and information requirements. If, based on pre-investment due diligence, an Alts Fund invests directly in an unblocked Underlying Private Fund, it will be crucial to obtain sufficient ongoing information regarding the Underlying Private Fund's income and holdings in order to ensure the Alts Fund's continued compliance with the RIC qualification tests. An Underlying Private Fund's operating agreements may create a commitment by the general partner or sponsor to provide limited partners with certain periodic information, including estimated Schedules K-1 shortly after the Underlying Private Fund's year-end. However, these standard undertakings are unlikely to be sufficient for RIC compliance purposes. Therefore, an Alts Fund should, where possible, specially request additional information; if it is unable to obtain this information from an Underlying Private Fund, it may want to reconsider investing directly into the Underlying Private Fund.

For instance, an Alts Fund generally must include in its income annually an underlying partnership's income for the partnership's taxable year that ends within the Alts Fund's taxable year. An Underlying Private Fund's taxable year-end is frequently December 31, and it is common not to receive a final Schedule K-1 tax package until the September following the Underlying Private Fund's year-end. If there is material, nonqualifying income passing through one or more Underlying Private Funds, there is a risk that it is too late for an Alts Fund to avoid a 10% nonqualifying income issue if it is not able to identify it until receipt of an estimated or final Schedule K-1. Therefore, the Alts Fund should seek to obtain monthly or quarterly information about the sources and amounts of gross income (including from any lower-tier funds) during the applicable period. Ideally, the general partner or sponsor is willing to provide a formal commitment to do so in the operating agreement or a side letter.

[8] Underlying Private Fund operating agreements usually allow for some transfers of interests to partners' affiliates, but those are typically subject to the prior consent of the general partner or sponsor.

Qualifying income considerations for private credit investments

Fee income

One common type of income that can raise qualifying income issues for a private credit Alts Fund are certain fees earned by the Alts Fund in connection with its (or an Underlying Private Fund's) lending activities. Very generally, fees that are regarded for tax purposes as compensation for the performance of services by a lender to a borrower with respect to a loan transaction are nonqualifying income (e.g., administration fees or certain structuring or origination fees). In contrast, fees intended to provide a lender with additional yield or compensation under the loan may be treated as qualifying income. For instance, this typically includes fees that are treated for tax purposes as interest income (including original issue discount, or OID) or as premium paid to the lender under a loan facility for standing ready to advance funds upon request. It is not uncommon for two fees with the same name to have different qualifying income treatments based on differences in how they are structured and described in the loan documentation. Therefore, an Alts Fund should not rely solely on the name of a fee to determine its tax and qualifying income treatment. The qualifying income analysis is fact-specific.

There are a few ways to manage these qualifying income issues in the private credit space. This can include creating a list of permissible fees, including detailed descriptions thereof, for fund management that an Alts Fund can earn in connection with a credit transaction. Ideally, this information includes the GAAP and tax treatment, as well as qualifying income status, of each fee. If an Alts Fund is investing in Underlying Private Funds that engage in private credit, the qualifying income due diligence outlined for Underlying Private Funds above under "Qualifying income considerations for private equity investments" also should be followed. If some nonqualifying fee income is unavoidable, the Alts Fund should ensure that income would be well under the 10% nonqualifying income bucket annually using conservative estimates for the Alts Fund's qualifying income. Otherwise, the Alts Fund should consider including the problematic loans in a blocker entity. See "Use of corporate entities" later in this article.

Equity tranches

An Alts Fund that receives deeply subordinated tranches of debt of the borrower as part of the initial loan transaction or a restructuring of an outstanding loan may also earn nonqualifying income on that debt if the borrower is a partnership or other flow-through entity and the debt is classified as equity for tax purposes. Qualifying income issues can arise for the same reason when an Alts Fund receives "equity kickers" (e.g., warrants) as part of a lending transaction. Use of a blocker entity also may be needed in these situations.

Quarterly asset diversification test

Basic test

At the end of each quarter of a RIC's taxable year:

- At least 50% of an Alts Fund's gross assets must be invested in qualifying assets, including cash and cash items, securities of other RICs, US government securities or investments in other securities, provided that its investment in the securities of any one issuer represents 5% or less of the Alts Fund's gross assets, and 10% or less voting rights of a single issuer ("50% test").
- No more than 25% of its gross assets can be invested in (1) a single issuer; (2) any two or more issuers controlled by the Alts Fund (i.e., owning 20% or more of the outstanding voting securities of a corporation) and engaged in the same, similar or a related trade or business; or (3) one or more QPTPs ("25% test").

The diversification test is generally intended to ensure that RICs, which Congress created to serve as pooling vehicles for retail investors, provide diversification of investments and do not operate as holding companies. Consistent with the qualifying income test, investments in assets that are not securities, such as real estate and commodities, are not qualifying assets for the asset diversification test.

Special considerations for diversification testing investments in Underlying Private Funds

Special considerations exist for Alts Funds investing in Underlying Private Funds. In particular, it is not clear under existing tax law whether a RIC should look through a partnership to its underlying holdings for purposes of compliance with the diversification tests. Given the uncertainty, some Alts Funds will test compliance both ways (i.e., (i) testing at the level of the Alts Fund's Underlying Private Fund interests and (ii) looking through an Underlying Private Fund that is a partnership (including further through any lower-tier partnerships in the Underlying Private Fund) to the underlying holdings.

Establishing that an Alts Fund complies quarterly with the asset diversification tests can be challenging for Alts Funds that invest substantially in Underlying Private Funds. As with the qualifying income test, prior to investing, an Alts Fund should review an Underlying Private Fund's operating agreement and other offering materials to see what investment holdings and other financial reporting the sponsor or general partner intends to provide to its limited partners on a periodic basis with respect to its holdings. As with the qualifying income test, a RIC's special testing needs will generally require an Alts Fund to request additional information from the Underlying Private Fund's sponsor or general partner, including quarterly schedules of an Underlying Private Fund's direct and indirect investments, and percentage ownership of outstanding voting securities of direct and indirect issuers. The Alts Fund will also need to obtain updated, quarter-end valuations of these investments. Again, pre-investment due diligence and planning are needed. An Alts Fund should seek to obtain a (preferably formal) commitment from an Underlying Private Fund's sponsor to provide this information.

Obtaining this quarterly information from Underlying Private Funds may be challenging. In constructing an Alt Fund's investment strategy and targeted investments, fund management should consider that the Alts Fund will need to obtain adequate information from the Underlying Private Funds with respect to a substantial portion of its overall portfolio to establish its quarterly compliance with the diversification tests.

Prior to launching, an Alts Fund should discuss with its auditor what their documentation and other support requirements are for their audit of the fund's qualifying income and diversification tests.

Cure provisions

The asset diversification tests have multiple types of cure provisions to remedy noncompliance at the end of a taxable quarter.

Market value exception

A RIC must satisfy the asset diversification tests at the end of each quarter of its taxable year. However, after the first quarter of its first year as a RIC, it will not fail the diversification tests simply by reason of market fluctuations in the value of its securities (market value exception). Specifically, the market value exception provides that, where a RIC's acquisition of a security during a quarter (other than its first) causes it to be undiversified at the end of the quarter, it will not fail the test if, immediately after the acquisition of that security during the quarter, the RIC met the test; this is a time-of-acquisition test. Therefore, if subsequent fluctuations in market value or distributions to shareholders to pay fund dividends or meet redemptions cause the RIC to be undiversified at the end of the quarter with respect to that security, the market value exception will apply, and the RIC will be considered to be in compliance with the test. However, additional acquisitions of the noncompliant security during the quarter can trigger a failure. Acquisitions of other securities during the quarter that themselves satisfy the test do not create a compliance problem.

30-day cure period

If a RIC is undiversified at the end of a quarter and cannot rely on the market value exception, it can still cure its noncompliance within 30 days of the close of the quarter typically by disposing of the portion of the assets that caused the noncompliance during that grace period (30-day cure period), although other means of curing the failure during the 30-day cure period may be available.

Other cure provisions

A savings provision exists for a de minimis asset test failure (i.e., failure is due to ownership of assets the total value of which does not exceed the lesser of (1) 1% of the RIC's total assets at the end of the quarter or (2) $10 million) that is cured within six months of the failure.

Finally, an Alts Fund can also cure other (non-de minimis) failures, provided that it meets certain requirements, including disposing of the offending securities or otherwise satisfying the test within six months of the failure, demonstrating that such failure was due to reasonable cause and not willful neglect, and paying a penalty excise tax equal to the greater of (1) $50,000 or (2) a corporate tax on the net income generated during the period of asset-test failure by the assets causing the Alts Fund to fail the test. Like the qualifying income test cure, the availability of this cure is based on an Alts Fund's specific facts and circumstances surrounding the failure.

Special considerations for Alts Funds in relying on a cure

RICs routinely rely on the market value exception and 30-day cure period to remedy noncompliance at the end of a quarter. However, application of, and reliance on, either can present challenges.

New "acquisitions"

As noted above, for the market value exception, new acquisitions of the noncompliant security during a quarter will eliminate a RIC's ability to use the market value exception. The term "acquisition" is not defined in the RIC rules, and the IRS has historically taken a broad view of what constitutes an acquisition for purposes of the market value exception. For instance, it has ruled that a RIC's receipt of securities as part of a tax-free merger of one of its portfolio securities is an acquisition. Similarly, lower-tier portfolio activities occurring during a quarter in an Underlying Private Fund could constitute an acquisition for the Alts Fund. An Alts Fund likely will not have any control of these activities or potentially even prior knowledge of them, so its reliance on the market value exception for Underlying Private Fund holdings can be risky. For instance, reliance on the market value exception is difficult if some of the Underlying Private Funds continue to have capital calls or the Alts Fund is in liquidation and needs multiple quarters (or years) to fully liquidate its Underlying Private Fund holdings.

In the private credit space, loan modifications and restructurings may constitute new acquisitions under the diversification tests, particularly if such modification or restructuring results in a taxable exchange (i.e., as a "significant modification" under the sale-or-exchange rules). Therefore, the Alts Fund manager should continuously monitor for these events.

Illiquid investments

Reliance on the 30-day cure period and other cure provisions also may be difficult for an Alts Fund because of the illiquidity of its holdings and an inability to dispose of the securities by the end of the applicable cure period.

Special considerations during first quarter of operations

The market value exception and 30-day cure period can be helpful compliance tools for RICs, but they are generally considered to be unavailable in the first quarter of a RIC's operations. Therefore, careful pre-launch planning with management is recommended to ensure that the test is met for the first quarter. Without this planning, failures can easily occur during an Alts Fund's ramp-up phase, particularly with a private equity strategy. Failure to meet the requirement in the first quarter of operations is generally not curable. This could mean an inability to qualify as a RIC for that year, which, in turn, could require the Alts Fund to operate as a regular taxable C corporation for the first year.

Section four

Use of corporate entities

Creation of corporate subsidiaries. An Alts Fund may create one or more wholly owned corporate subsidiaries to prevent any nonqualifying income or nonqualifying assets from being attributed to the Alts Fund for purposes of the RIC qualification tests. Such entities are typically referred to as "blockers." Alternatively, if available, an Alts Fund may invest through an Underlying Private Fund's corporate feeder fund. While it is unusual for an Underlying Private Fund to have a corporate feeder fund specifically dedicated to RICs and their unique nonqualifying income challenges, Underlying Private Funds routinely set up these dedicated corporate feeder funds to prevent UBTI and ECI from flowing to US tax-exempt and foreign investors, respectively. Alts Funds generally can invest through those feeders, and they will have the desired blocking effect for RIC nonqualifying income. However, because of the different tax rules applicable to RICs and US tax exempts, for instance, these feeders can have the effect of blocking some qualifying RIC income, along with the nonqualiyfing income.

Domestic corporations. In general, a domestic entity (e.g., LLC or corporation) that is, or elects to be, a corporation for US federal income tax purposes is used for assets producing US active trade or business income or other US-source nonqualifying income or assets (e.g., US real estate). Income earned in the domestic corporation will be subject to federal and state corporate income taxes, thus creating additional tax costs which can reduce an Alts Fund's overall investment return. An Alts Fund's proprietary domestic corporation can require it to make estimated tax payments and accrue deferred tax assets and liabilities for financial accounting purposes, including for purposes of calculating the Alts Fund's net asset value.

Foreign corporations. A foreign entity that is, or elects to be, a corporation for US federal income tax purposes is generally used for assets producing non-US active trade or business income or other non-US source, nonqualifying income or assets (e.g., commodity futures), and set up in a jurisdiction where it is not subject to local taxes (e.g., the Cayman Islands).

Therefore, blockers, in particular an Alts Fund's wholly owned corporate subsidiaries, add additional legal, tax and accounting compliance costs. While the use of these corporations can be seen as essential from a RIC tax compliance perspective, more generally, their use can be tax-inefficient and costly for the Alts Fund and its shareholders. Fund management should work with the Underlying Private Funds' sponsors and their outside legal and tax advisers to balance most effectively these competing factors. For instance, in some cases, instead of investing through a corporate entity, an Underlying Private Fund may be able to structure its partnership arrangement so that only the nonqualifying RIC income is running through a corporation, or, in lieu of a corporation, the partnership does not allocate nonqualifying income to RIC partners.

Corporate subsidiaries and compliance with the 25% test

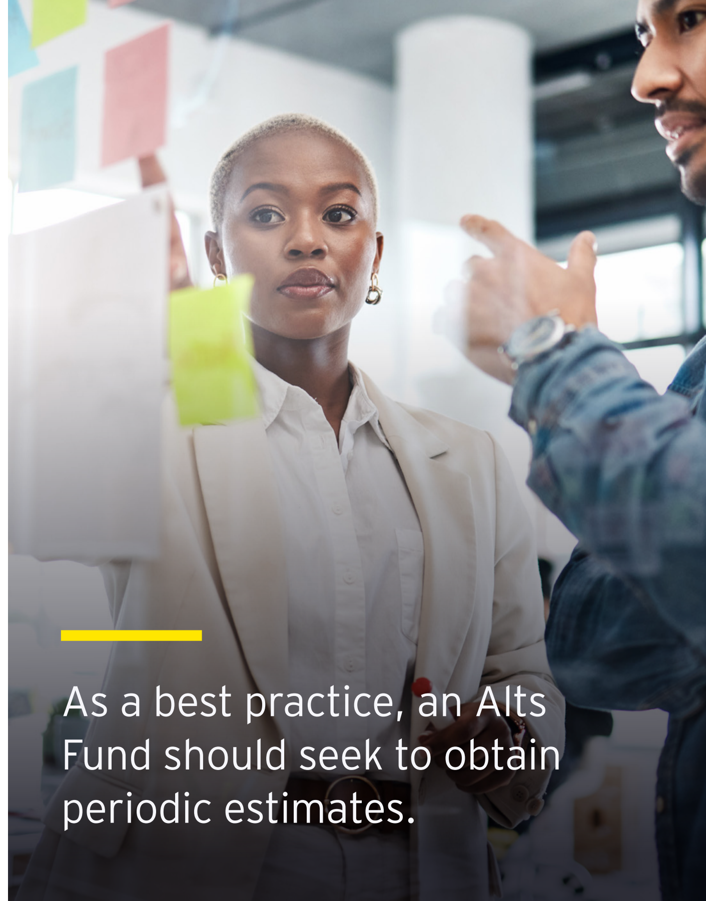
As discussed above, under the 25% test, a RIC cannot invest more than 25% of its gross assets in the securities of a single issuer. Therefore, an Alts Fund's investment in a single corporation cannot constitute more than 25% of the Alts Fund's total assets. As discussed above, US private equity funds typically create corporate feeder funds for US tax-exempt and foreign investors, and a RIC investor should generally also be able to invest through these feeder funds. As a matter of best practice, an Alts Fund should invest in an Underlying Private Fund's feeder fund, when possible, and reserve the Alts Fund's proprietary, wholly owned corporate subsidiaries for situations in which an Underlying Private Fund's blocker is not available. This practice can help reduce the impact of the 25% test on an Alts Fund's investment strategy.

Moreover, an Alts Fund's corporate investments must be analyzed under the 25% test's requirement that no more than 25% of a RIC's total assets be invested in two or more issuers that are controlled by the fund and that are in the same, similar, or related trades or businesses (same trade or business standard). For this purpose, control is defined generally as owning 20% or more of the outstanding voting securities of a corporation.[9] An Alts Fund will typically be considered to control its wholly owned corporations, as well as any Underlying Private Fund's corporate feeder funds of which it owns 20% or more voting securities. Once control is present, these controlled corporations must be analyzed to determine whether two or more of them meet the same trade or business standard and, if so, would require aggregation for the 25% test. To avoid this aggregation issue, where possible, an Alts Fund should seek to invest in Underlying Private Fund-sponsored entities that it does not control (i.e., owns less than 20% of a corporation's outstanding voting securities).

[9] The 25% test also requires that a RIC look through any controlled corporation to its underlying investments. A RIC is deemed to own its proportionate share of an underlying investment in the controlled blocker for purposes of the 25% test. For instance, in a private credit Alts Fund, debt of an issuer held at the RIC level may need to be combined with any equity of that same issuer held in a RIC's wholly owned blocker to determine whether the Alts Fund is in compliance with the 25% test as to that issuer.

Section five

Distributions and excise tax



RIC qualification distribution requirement

To qualify as a RIC each taxable year, an Alts Fund must distribute to its shareholders on a timely basis at least 90% of its investment company taxable income (ICTI), which is generally defined as net ordinary income plus any net short-term capital gain in excess of any net long-term capital loss. The remaining 10% of ICTI and any net long-term capital gain are not required to be distributed to maintain an Alts Fund's RIC qualification. However, the Alts Fund would be taxed at the federal corporate income rate (currently 21%) on any such undistributed ICTI or long-term capital gain.[10] In practice, most Alts Funds make the necessary distributions to avoid incurring any fund-level income tax. A fund-level tax is avoided through a "dividends-paid deduction" that a RIC is permitted to take against its taxable income on the year. Very generally, in order to meet the 90% requirement and avoid any fund-level income taxes for a taxable year, RICs have until the end of the following taxable year to distribute the required amounts.

Impact on distributions of certain foreign investments

In both the private credit and equity space, Alts Funds may invest directly or indirectly (e.g., through an Underlying Private Fund) in foreign entities, including foreign corporations discussed above, that are either passive foreign investment companies (PFICs)[11] or controlled foreign corporations (CFCs)[12] for US federal tax purposes. Under the Code's anti-deferral rules for US investors in PFICs, Alts Funds generally will be required to include in their income annually their pro rata shares of a PFIC's net income regardless of whether the foreign entity has made a cash distribution of such income to its shareholders during that year.

An Alts Fund can include a PFIC's income in its taxable income annually pursuant to a mark-to-market (MTM) election or qualified electing fund (QEF) election. Under the MTM election, the Alts Fund would be required to include in taxable income annually any excess of the fair market value of its PFIC stock over its adjusted basis in the stock; such excess is taxed as ordinary income, not capital gain. The QEF election is generally more favorable for an Alts Fund and its shareholders because, unlike the MTM election, it allows for the pass-through of the PFIC's net capital gains, and there is no current recognition of unrealized capital gain. For the QEF election, the PFIC must agree to provide its owners with a QEF tax information statement annually concerning its net income and gains.

Similarly, under the Code's anti-deferral rules for "United States shareholders"[13] in CFCs, an Alts Fund that is a United States shareholder in a CFC needs to include in its taxable income annually its proportionate share of the CFC's "subpart F income" (generally, a CFC's passive income), as well as its "global intangible low-taxed income" (GILTI) (if any), whether or not the CFC has distributed the income. Thus, the Alts Fund should seek to obtain the foreign entity's subpart F income and GILTI amounts annually. As a best practice, an Alts Fund should seek to obtain periodic estimates during the year of the PFIC or CFC income inclusion amounts to help the Alts Fund appropriately manage the level of distributions that it, in turn, needs to make to its shareholders under the RIC requirements, as well as manage cash levels for such distributions.

[10] For net long-term capital gain, an Alts Fund can opt to designate the retained amount on which it pays taxes as undistributed capital gain in a special notice to shareholders. Shareholders would then, in turn, be (i) required to include in their taxable income, as long-term capital gain, their shares of such undistributed capital gain and (ii) entitled to credit their proportionate shares of the tax paid by the Alts Fund on such undistributed amount against their US federal income tax liabilities (or, if credit is in excess of their taxes paid, claim a refund of any excess).

[11] Very generally, a PFIC is a foreign corporation for its taxable year if it meets the applicable income test (75% or more of its gross income is passive income) or assets test (at least 50% of the average percentage of assets held by the corporation during the year are assets that produce passive income or that are held for the production of passive income).

[12] Very generally, a CFC is a foreign corporation that is more than 50% owned by United States shareholders by vote or value. See note 13 for definition of United States shareholders.

[13] Very generally, a "United States shareholder" is a domestic person who directly, indirectly or constructively owns 10% or more of a CFC by vote or value. These rules are triggered if the Alts Fund itself is a US shareholder in a CFC (e.g., a wholly owned foreign corporate subsidiary) or if the Alts Fund is investing in an Underlying Private Fund that is a US shareholder in a CFC.

Timing considerations

Alts Funds with significant Underlying Private Fund investments can experience challenges managing the appropriate level and reported character of distributions due to a need to use estimates where available, from Underlying Private Funds (and partnerships and PFICs/CFCs in which they invest) and the sometimes-sizeable time gap between the receipt of final Schedule K-1 or other relevant tax reporting. Management should discuss with their tax advisers best practices for managing this process, including selection of an optimal taxable year-end (which may differ from the Alts Fund's fiscal year-end).[14] For non-BDC Alts Funds, Rule 19b-1 under the 1940 Act, which limits the number of net long-term capital gain dividends a fund can distribute annually, also should be a consideration.

Private credit considerations

It is common for a private, credit-focused Alts Fund (typically BDCs) to modify or restructure the credit agreements with its borrowers at some point during their term. Loan modifications and restructurings, as well as defaults during a fund's year, can impact the level and character of an Alts Fund's required distributions for that year. Therefore, these types of credit events should be monitored by, and communicated to, the tax team on a regular basis so that appropriate estimates of income, gain and loss can be made or updated.

Cash management and dividend reinvestment programs

An Alts Fund may need to manage its available cash to make distributions. Alts Funds with large amounts of phantom income, for instance, due to CFC/PFIC investments or OID on loans, may need to keep cash on hand during the year to make sufficient levels of income distributions or sell securities or other assets to raise cash for a distribution. The former can create a so-called "cash drag" on an Alts Fund's investment returns, and the latter can be challenging due to the illiquid nature of Alts Funds' investments.

To help manage these issues, where permitted, Alts Funds should consider establishing dividend reinvestment programs and making dividend reinvestment (not cash) the default option for shareholders on distributions. This will help reduce the amount of cash that an Alts Fund needs to raise or hold for distributions. In addition, under IRS guidance, if an Alts Fund is a "publicly offered RIC" (as defined in "Private RICs" below), it may also be able to avail itself of a special dividend mechanism that caps the overall amount of cash to be paid as part of the dividend at 20% or higher of the total dividend, with the remainder paid as stock; under IRS guidance, the total amount of both cash and stock distributed counts toward the RIC's dividends-paid deduction.

Excise tax distribution requirement

Alts Funds must be aware of the separate RIC distribution requirement in the excise tax rules of the Code. These rules require that, for each calendar year, a RIC must distribute at least (i) 98% of its ordinary income for the calendar year and (ii) 98.2% of its capital gain net income for the 12 months ending October 31 within that year. Failure to do so does not create a RIC qualification issue, but instead will result in a 4% nondeductible federal excise tax on the shortfall. To avoid the excise tax, distributions generally must be made by December 31 of the applicable calendar year.

In general, RICs seek to avoid payment of excise taxes. However, in some cases, Alts Funds, in particular BDCs, may determine to pay some excise tax for a calendar year. For instance, fund management may determine that the benefits of remaining fully invested outweigh the excise tax and costs of having to sell a portion of a fund's portfolio to raise cash for the distribution. An excise tax may also arise because a fund maintains a fixed or steady dividend rate throughout the year. Note that, whether or not an Alts Fund makes an excise distribution to avoid the 4% excise tax, it still needs to meet the RIC qualifying distribution requirement discussed earlier in order to qualify as a RIC.

In addition, Alts Funds investing significantly in Underlying Private Funds and/or directly or indirectly in foreign entities that are PFICs or CFCs can have particular difficulty estimating their net income and gains at excise time in order to avoid incurring excise taxes on the year. The excise tax rules effectively require an Alts Fund to have a reasonably good estimate of the Alts Fund's calendar-year income and October 31-period gains by December 31, which means that it, in turn, needs reasonably good estimates of taxable income and gains from the Underlying Private Funds. Depending on the type of Underlying Private Fund, estimates can vary significantly from the actual amounts on the final Schedule K-1. Consequently, an Alts Fund may end up with an excise tax liability (for underdistributions) or a return of capital (for overdistributions) for a taxable year.

[14] Alts Funds with substantial Underlying Private Fund investments will frequently adopt a March 31 fiscal year-end and September 30 tax year-end. This timing also helps with year-end audit valuation and RIC diversification testing.

Shareholder taxation of distributions

US shareholders

Distributions of a RIC's annual net investment income and gains are generally taxable in the hands of its investors as ordinary income or long-term capital gain. While distributions attributable to long-term capital gain can be reported to shareholders as such, distributions attributable to short-term capital gain are reported to shareholders as ordinary income. However, RICs are able to pass through the tax character of certain other types of investment income (in addition to long-term capital gain). This includes income eligible for long-term capital gain rates as qualified dividends or for the corporate dividends-received deduction, or as "Section 163(j)" interest. Distributions in excess of a RIC's annual net investment income and gains are generally treated as returns of capital. Returns of capital are nontaxable to shareholders to the extent of their adjusted cost bases in their shares, and thereafter as long-term or short-term capital gain depending on the shareholders' holding period in their shares.

In general, RICs are required to report the final tax character of their distributions on Forms 1099-DIV to shareholders in January or February of each calendar year. For the reasons discussed earlier, Alts Funds investing substantially in Underlying Private Funds can have challenges determining the final tax character of distributions in time for the Forms 1099-DIV and, as a result, have a higher risk of having incorrect and inaccurate Forms 1099-DIV for a year. Failure to file and distribute corrected Forms 1099-DIV can subject the Alts Fund to IRS information-reporting penalties. Further, issuing corrected Forms 1099-DIV can be expensive and create additional tax compliance burdens for shareholders who may need to amend their already-filed tax returns. Therefore, fund management should discuss with their tax advisers best practices for managing this process. For instance, this may include limiting the number of distributions that a fund makes for a year.

Foreign shareholders

Alts Funds with US private credit strategies have become increasingly popular with foreign investors. They can benefit from US withholding tax exemptions for the portion of a RIC's distributions reported as attributable to qualified interest income (generally, interest that an Alts Fund receives from US borrowers on loans in registered form), net long- or short-term capital gain, or return of capital. In some cases, dividends paid by an Alts Fund may not be reported as eligible for these exemptions until the beginning of the following calendar year (typically at the same time as the Form 1099-DIV amounts are disclosed). If so, a foreign investor may need to file with the IRS to obtain a refund of the withholding on certain distributions.

Section six

Tax filings

Alts Funds that are RICs are required to file a fund-level corporate income tax return on IRS Form 1120-RIC annually. Investments in Underlying Private Funds with direct or indirect foreign investments, as well as in blocker and other foreign entities, can trigger the filing of additional information returns along with the Form 1120-RIC. These may include:

Form 5471

Information Return of US Persons with respect to Certain Foreign Corporations

Form 926

Return by a US Transferor of Property to a Foreign Corporation

Form 8621

Information Return by a Shareholder of a PFIC or Qualified Electing Fund

Form 8865

Return of US Persons with respect to Certain Foreign Partnerships

Form 8858

Information Return of US Persons with respect to Foreign Disregarded Entities and Foreign Branches

Form 8992

US Shareholder Calculation of GILTI

When investing in Underlying Private Funds, Alts Funds should consider the information required to complete these forms prior to investing and, if necessary, request from the sponsors the information needed to do this reporting, along with the other items for RIC qualification and excise tax determination discussed earlier. Alts Funds that are RICs also may be required to file foreign, state or local tax returns depending on their investments. Alts Funds should discuss these filing requirements with their tax advisers.

Section seven

Management fees

Alts Funds generally charge an asset-based management fee like traditional mutual funds and ETFs. They can also charge a performance fee based on interest and dividend income. However, non-BDC Alts Funds cannot charge a performance fee based on capital gains or capital appreciation, unless they limit their sales of shares to "qualified clients" under the Investment Advisers Act of 1940. BDCs may charge a performance fee based on capital gains or appreciation, subject to certain limitations, even if those shareholders are not qualified clients. Performance fees based on capital can create book and tax differences for the Alts Fund related to the timing of the deductions from a fund's taxable income.

Further, all of these management fees, including capital-based performance fees, are taxable to the investment manager as ordinary income. They are not eligible for the favorable capital gain rates for which carried interest earned by investment managers of private equity funds qualifies.

Section eight

Private RICs

Special tax issues arise for an Alts Fund and its shareholders if the Alts Fund is not a "publicly offered RIC." A RIC is considered to be publicly offered if its shares are continuously offered pursuant to a public offering registered under the Securities Act of 1933 (the Securities Act), regularly traded on an established securities market, or held by or for at least 500 persons at all times during the RIC's taxable year. A privately offered, unlisted Alts Fund can have difficulty meeting any of these criteria and thus would be considered to be not publicly offered.

Special tax issues arise for an Alts Fund if it is not a "publicly offered RIC."

Nondeductible expenses for noncorporate shareholders

Noncorporate shareholders in an Alts Fund that is not publicly offered are treated as having (i) received or accrued a taxable dividend in an amount equal to the noncorporate shareholders' allocable share of certain "affected RIC expenses" (e.g., its investment management and custodian fees) for the calendar year, and (ii) paid or incurred the shareholders' allocable share of the affected RIC expenses for the calendar year. The Alts Fund is required to report these amounts on the Form 1099-DIV for the applicable calendar year.

The reported affected RIC expenses are treated as "miscellaneous itemized deductions" under Section 212 of the Code and thus are disallowed entirely through 2025; unless Congress makes changes to the statute between now and 2025, they are subject to limitation thereafter. This generally means that noncorporate shareholders in non-publicly offered RICs will have phantom income annually equal to the amount of the affected RIC expenses.

The calculation of what components of an Alt Fund's expenses are affected RIC expenses can be complex. As an alternative to computing affected RIC expenses, the applicable Treasury regulations permit an Alts Fund to elect to treat 40% of its aggregate expenses, which are allowable in computing taxable income, as affected RIC expenses for the calendar year. A de minimis rule also exists where an Alts Fund's affected RIC expenses will be treated as zero if below a specified threshold.

Preferential dividend rule

Alts Funds that are not publicly offered are also subject to the so-called "preferential dividend" rule.[15] If any distribution made by a non-publicly offered RIC is treated as preferential, the entire amount of the distribution will not qualify for purposes of meeting the 90% distribution requirement or the dividends-paid deduction. A distribution can be preferential unless it is pro rata, with no preference as to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class, except to the extent that the former is entitled to such preference.

Under the 1940 Act, Alts Funds generally cannot vary the management fees that they charge to their shareholders, including by share class. However, in some cases, if permitted under the 1940 Act, management may enter into side letters or other separate arrangements outside of the Alts Funds themselves with particular Alts Fund investors that, indirectly, can have a similar economic effect. The IRS has extended the reach of the preferential dividend rule to situations where there are indirect differences in management fees paid by shareholders. Therefore, fund management should work with legal counsel and tax advisers to structure any such arrangements with these preferential dividend issues in mind.

[15] Since 2010, the preferential dividend rule applies to only RICs that are not publicly offered.

Section nine

Creating and seeding an Alts Fund

It is relatively common for an Alts Fund to commence operations by converting a private fund that is a partnership for tax purposes into the Alts Fund or by having the investment manager (or an affiliate) or one or more large institutional investors contribute the initial seed cash or securities or other assets to the Alts Fund.

These types of transactions are generally nonrecognition events for tax purposes. However, there are a number of federal income tax nuances associated with these types of transactions, and a number of exceptions to this general rule may apply. In particular, if the securities or other assets being transferred into the Alts Fund through a conversion of a private fund or by a seed investor have an overall net built-in gain, a special tax on those gains may apply to the extent that any partner in the converting private fund or the seed investor is a taxable corporation.[16] Given the complexity, this process needs to be planned carefully with legal counsel and tax advisers.

[16] In some cases, this can extend to indirect, upstream taxable corporations (e.g., that own a flow-through partner or seed investor).

Section ten

Final thoughts

We expect the popularity of Alts Funds in the retail space to continue to grow, presenting new opportunities for both traditional and alternative asset managers. Alternative asset managers should be cognizant of the regulatory and tax requirements and costs of compliance of operating a 1940 Act registered vehicle. Managers of traditional private funds may be unfamiliar with the special tax requirements discussed in this article of operating a registered Alts Fund. Additionally, while traditional asset managers generally will be familiar with the tax requirements applicable to registered funds, they should prepare for the additional and unique tax considerations and challenges that Alts Funds can present relative to traditional mutual funds and ETFs. To help ensure success, managers should work with their tax advisers, auditors, legal counsel, and others with knowledge of Alts Funds tax compliance in developing, launching and operating an Alts Fund.

Appendix

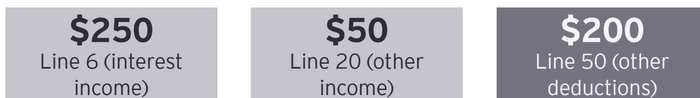
Reviewing an Underlying Private Fund's Schedules K-1

There can be limited transparency into what types of income are flowing through and reported on Schedules K-1. Line items can be made up of a mix of qualifying and nonqualifying income, so it is necessary to drill down on certain line items. In reviewing the Schedules K-1 for qualifying income, it is important to understand that some items are reported on a net basis. However, the RIC qualifying income test requires testing on the basis of gross income — that is, income or gain earned directly or indirectly and not reduced by expenses or losses. Therefore, even though an Underlying Private Fund's Schedule K-1 is showing a net loss in Box 1, the Alts Fund would need to include any gross income that was offset by the gross losses in its qualifying income testing. Schedules K-3 provide more detailed information on the Schedule K-1 amounts for this gross income analysis, but it may not always be sufficient, and an Alts Fund may need to request additional information from the Underlying Private Fund.

The following examples demonstrate the type of analysis that may be necessary for different types of Underlying Private Funds:

Example 1, Underlying investment in private credit fund

RIC A invests in Partnership B, which is a private credit fund. Partnership B provides a Schedule K-1 with $100 on Line 1 (ordinary business income (loss)). RIC A needs to look to the Schedule K-3 for more details on this amount. Schedule K-3, Part II shows the following:

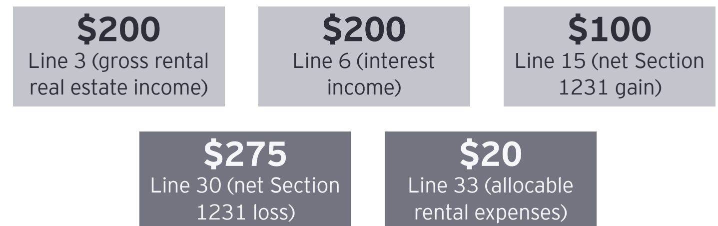


The $200 other deduction is ignored for the RIC qualifying (gross) income calculation. The $250 interest income is qualifying income, but the $50 other income requires further investigation. RIC A asks Partnership B for more information. Partnership B indicates that the $50 consists of origination fees on its loans. RIC A treats origination fees as nonqualifying income. Thus, RIC A has $250 of qualifying income and $50 of nonqualifying income from its Partnership B investment.

Example 2, Underlying investment in private equity secondaries

RIC A purchased limited partner interests in a pool of Underlying Private Funds purchased on the secondary market. RIC A did not have time to conduct a thorough tax due diligence on each LP interest prior to purchase. RIC A nevertheless decided to invest directly in the Underlying Private Funds' partnerships, not through blockers. Several months later, RIC A received Schedules K-1 and K-3 from the Underlying Private Funds for RIC A's first year as a partner.

Schedules K-1 from the Underlying Private Funds, collectively, show $200 on Line 1 (ordinary business income (loss)), $180 on Line 2 (net rental real estate income (loss)) and ($175) on Line 10 (net Section 1231 gain (loss)). The Underlying Private Funds' Schedules K-3 provide more detail, collectively, showing the following in the Schedules' Part II:



The net Section 1231 loss and allocable rental expenses are ignored for the RIC qualifying (gross) income calculation. RIC A has $300 of nonqualifying income from gross rental real estate income ($200) and net Section 1231 gains ($100). RIC A has $200 of qualifying income from interest income from the Underlying Private Fund investments. RIC A earns $500 of gross qualifying income from other investments in RIC A during the year. RIC A has gross income of $1,000, consisting of $700 of qualifying income and $300 of nonqualifying income. RIC A fails the qualifying income test — 30% of its gross income is nonqualifying ($300/$1,000).

RIC nonqualifying income chart

The following is a list of common sources of RIC nonqualifying income reported on Underlying Private Funds' Schedules K-1, Partner's Schedule of Income, Deductions, Credits, etc.

Common Sources of Nonqualifying Income in Schedule K-1, Part III
Operating income Line 1 (ordinary business income (loss))
Real estate Line 2 (net rental real estate income (loss)) Line 3 (other net rental income (loss))
Royalties Line 7 (royalties)
Capital gain (loss) Line 8 (Net short-term capital gain (loss))* Line 9a (Net long-term capital gain (loss))* Line 9b (Collectibles (28%) gain (loss))** Line 9c (Unrecaptured Section 1250 gain)** Line 10 (Net Section 1231 gain)
Other income (loss) Line 11 (check codes)*

*Check sources of income or gain; can be mix of qualifying and nonqualifying sources.
** Generally nonqualifying unless passed through from an underlying REIT or QPTP.

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US SCORE no. 23216-241US
2311-4384117
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