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To RIC or Not to RIC . . . An Analysis of Tax Issues When Converting to a Regulated Investment Company

*By Christopher C. Scarpa**

Conversion is not the smooth, easy-going process some men seem to think. . . It is wounding work, this breaking of the hearts, but without wounding there is no saving. . .[1]

INTRODUCTION

Private investment funds ("hedge funds") holding portfolio securities such as stocks, bonds, or derivatives and taxed as partnerships[2] sometimes decide to convert to corporations taxed as regulated investment companies ("RICs") for federal income tax purposes. A number of business reasons are cited for such conversions, including the enhanced transparency offered by RICs registered under the Investment Company Act of 1940 (the "1940 Act") and the Securities Act of 1933 (the "1933 Act"),[3] enhanced liquidity opportunities[4] for holders of the fund, and a better opportunity to grow assets under management.[5] In many conversion transactions, the private fund (sometimes referred to herein as the transferor partnership) contributes its portfolio securities to a newly formed entity that intends to elect and qualify as a RIC for federal income tax purposes in exchange for all of the shares of the RIC and then distributes such shares to its partners, as a liquidating distribution, in proportion each partner's percentage ownership interest in the partnership.[6] This article explores some of the federal tax nuances of such conversions, including the application of possible exceptions to the general nonrecognition rules that most taxpayers expect to be applied to the conversions.

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[1] John Brown, *John Bunyan His Life Times and Work* (1888).

[2] The "partnership" could be formed as a state law limited partnership or as a state law limited liability company. Because the entity typically has multiple members, its default classification for federal income tax purposes usually is an entity taxed as a partnership (provided that it avoids classification as a publicly traded partnership taxable as a corporation).

[3] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74, as amended (1933) (15 U.S.C. §77a *et seq.*). The RIC would need to file semiannual and annual reports, and would also need to file N-Q reports with the SEC for quarters when semiannual and annual reports are not due.

[4] The ability of a private fund investor to exit the fund depends on the terms and conditions set forth in the partnership or limited liability company agreement, which typically permit an investor to redeem all or part of its interests on a month-end or quarter-end basis. In the case of a RIC registered under the 1940 Act, the RIC would strike a daily net asset value, and shareholders would have the right to tender their shares for redemption at any time assuming that the RIC is an open-end fund.

[5] A private fund has limits on either the types of and/or number of investors to comply with applicable securities laws exempting them from registration under such laws. In the case of a RIC, its shares can be distributed more broadly through varied channels.

[6] Typically, the conversion is approved by the general partner, if the partnership is organized as a limited partnership, or the managing member, if the entity is organized as a limited liability company. The limited partners (in the case of a limited partnership) or members (in the case of a limited liability company) normally do not have the right to approve such transactions under the private fund's organizational documents.

SECTION 351

Section 351[7] provides that shareholders do not recognize gain or loss on certain transfers of property to a controlled corporation.[8] At the corporate level, §1032(a) provides that a corporation does not recognize gain or loss when it receives money or property in exchange for its stock. The rationale for these rules generally is that the formation of a corporation involves a mere change in the form of a person's investment and, thus, applying federal income tax to such a transaction is inappropriate.

RIC as a Corporation

A customary fact pattern in the partnership to RIC conversion is that a new entity, typically a new series of a business trust under state law, is formed that intends to elect and qualify to be taxed as a RIC. Section 851(a) defines a RIC, in part, as a domestic corporation. For this purpose, a corporation is ''domestic'' if it is ''created or organized in the United States or under the law of the United States or of any State.''[9] Under §7701(a)(3), the term ''corporation'' includes an ''association.'' Therefore, an association taxable as a corporation can qualify as a RIC.

Under the entity classification rules, a business trust, as an unincorporated entity, generally is taxed as a partnership unless it elects to be treated as an association taxable as a corporation.[10] A ''publicly traded partnership'' under §7704, assuming that it does not qualify for one of the exceptions to tax treatment as a corporation, is taxed as a corporation for federal income tax purposes. Section 7704(b) provides that a partnership is ''publicly traded'' 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). Interests are viewed as readily traded on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market.[11] The ability to redeem the interests in a partnership generally is taken into account in determining whether the partners are able to sell their interests. Privately placed partnerships (i.e., placements where all interests in the partnership are issued in transactions that are not required to be registered under the 1933 Act) that have no more than 100 partners can avoid classification as a publicly traded partnership taxed as a corporation under a private placement exception set forth in the regulations.[12] Under §7704(c) and §7704(d), a partnership is not taxed as a corporation, even if it would otherwise be viewed as being publicly traded, if it derives at least 90% of its gross income from certain qualifying sources. Under §7704(c)(3), however, the ''qualifying income'' exception generally does not apply to a partnership registered as an investment company under the 1940 Act.

An unincorporated entity, such as a series of a business trust, that intends to elect and qualify to be taxed as a RIC, can file IRS Form 8832 (''Entity Classification Election) to elect to be treated as a corporation for federal income tax purposes.[13] However, an unincorporated investment company registered under the 1940 Act normally would be treated as a corporation for federal income tax purposes, even without the filing of Form 8832, as it would be classified as a publicly traded partnership taxable as a corporation pursuant to §7704. Assuming, for example, that the investment company is an open-end investment company, its shares are redeemable upon the demand of the shareholder and, in the case of a closed-end investment company, its shares would be traded on an exchange or in the secondary market. An investment company registered under the 1940 Act usually cannot claim the benefit of the private placement safe harbor[14] from treatment as a publicly traded partnership taxable as a corporation because its shares would be sold in a public offering and it normally would have more than 100 owners. Finally, under §7704(c)(3), the qualifying income exception for avoiding classification as a publicly traded partnership taxable as a corporation does not apply to a 1940 Act registered investment company.[15]

General Requirements for Nonrecognition Under §351

In general, the requirements for nonrecognition treatment under §351(a) are: (1) one or more persons (including individuals, corporations, partnerships and other entities) must transfer property to a corporation;

[7] ''Section'' or ''§'' references are to the Internal Revenue Code of 1986, as amended (the ''Code''), and references to ''Reg. §'' are to the Treasury Regulations issued thereunder, unless otherwise indicated.

[8] §351(a).

[9] §7704(a)(4).

[10] Reg. §301.7701-2(b)(2) and §301.7701-3.

[11] Reg. §1.7704-1(b)(5), §1.7704-1(e)(3), §1.7704-1(f).

[12] Reg. §1.7704-1(h).

[13] Reg. §301.7701-3(c).

[14] Reg. §1.7704-1(h).

[15] The rules for REITs are different (and easier). Reg. §301.7701-3(c)(1)(v)(B) provides that an election to be a taxed as a REIT is deemed an election to be an association taxable as a corporation.

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(2) the property must be transferred solely in exchange for stock of the transferee corporation; and (3) the transferors, as a group, must be in control of the corporation immediately after the exchange.[16] Property for this purpose includes cash, investment securities, and intangibles. The transferor partnership must transfer all substantial rights in the property transferred to the new corporation. The transferor partnership must take back stock in the new corporation (i.e., an equity ownership interest in the new corporation).

To be in control of the new corporation, the transferor partnership must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of each class of nonvoting stock.[17] The timing of when the control requirement is tested also is important. The transferor partnership must have control of the new corporation immediately after the exchange of its investment securities for stock of the new corporation. Disposition of the stock shortly after incorporating raises the issue as to whether the control test should be applied before or after the disposition.

''Investment Company'' Exception to Application of §351

Under §351(e)(1), the general nonrecognition rule of §351 does not apply to a transfer of property to an ''investment company.'' A transfer of property will be treated as a transfer to an ''investment company'' if:

1. The transfer results, directly or indirectly, in ''diversification'' of the transferors' interests; and
2. The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation (''80% corporation'') more than 80% of the value of whose assets (excluding cash and nonconvertible 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% corporation now takes into account all stock and securities (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.[18]

In many conversions of private funds to RICs, the private fund's assets consist of readily marketable stocks and securities; therefore, the status of the corporate transferee as an ''investment company'' turns on whether the transfer results in diversification of the transferors' interests. The determination of whether a corporation is an investment company ordinarily is made by reference to the circumstances immediately after the transfer in question.[19] However, where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, the determination is made by reference to the later circumstances.[20] A rea-

[16] §351(a).

[17] §368(a). Typically, all shares of an open-end 1940 Act registered investment company are voting shares.

[18] Reg. §1.351-1(c)(1). The second prong of the test as detailed in the Treasury regulation was overridden in 1997 by the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34). Section 351(e) enlarges the concept of an 80% corporation. Section 351(e) provides that, ''For purposes of the preceding sentence, the determination of whether a company is an investment company shall be made—(A) by taking into account all stock and securities held by the company, and (B) by treating as stocks and securities—(i) money, (ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives, (iii) any foreign currency, (iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in §7704(b)) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii), (v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution, (vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii), (vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii), or (viii) any other asset specified in regulations prescribed by the Secretary. The Secretary may prescribe regulations that, under appropriate circumstances, treat any asset described in clauses (i) through (v) as not so listed.''

[19] Reg. §1.351-1(c)(2).

[20] *Id.* Transfers of securities in-kind to a newly formed corporation that intends to elect and qualify to be taxed as a RIC for federal income tax purposes should be accomplished pursuant to a ''plan of transfer'' or similar document that links together all transfers in-kind as part of the same plan and establishes the group that is in control of the corporation immediately after the transfer(s). Depending on the circumstances, the plan could be rather short and simple to document the intention of the parties to the plan that the transfer(s) constitute a tax-free contribution to capital under §351 and specify the date of transfer (or the time period within which all transfers intended to be part of the same plan will be accomplished). Two or more unrelated partnerships can come together to form the new corporation and it is also possible that the assets of one or more separate accounts can be contributed to a new corporation that elects and qualifies to be taxed as a RIC in a transaction that qualifies as tax-free pursuant to §351. It is also possible to create two RICs pursuant to a tax-free §351 transaction from one pool of assets. (See, for example, PLR 9820123, in which the IRS ruled that a partnership could transfer its assets to

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sonable inference from these rules is that a later series of in-kind transfers to a corporation that are not part of the ''same plan'' as an earlier series of in-kind transfers to the same corporation stand on their own. This means that any issue encountered during the first series of in-kind transfers should not taint the second series of in-kind transfers and vice versa.

The issue of whether in-kind transfers are part of the same ''plan'' generally is determined based on the step-transaction doctrine. The step-transaction doctrine is a variation on the substance-over-form doctrine, the purpose of which is to ensure that transactions are taxed according to their substance and not their outward form.[21] Accordingly, a court will not apply the step-transaction doctrine if the substance of the transaction does not differ from its form.[22] Generally, the step-transaction doctrine analysis considers: the intention of the parties;[23] time interval between the transactions;[24] and the mutual interdependence test.[25]

General Rules for Diversification Testing

If there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer(s) generally will not be treated as resulting in diversification.[26] On the other hand, a transfer ordinarily results in the diversification of the transferors' interests if two or more transferors transfer nonidentical assets to a corporation in the exchange.[27] 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, those transfers are disregarded in determining whether diversification has occurred.[28] If a transfer is part of a plan to achieve diversification without recognition of gain, such as a

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two RICs on a tax-free basis and then liquidate tax-free.)

[21] *See, e.g., Commissioner v. Clark*, 489 U.S. 726, 738 (''Under [the step-transaction] doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.''); *Kanawha Gas & Util. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954) (''[Substance-over-form] is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated.''); *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) (''The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form.''); *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (the step-transaction doctrine is an ''incarnation of the basic substance over form principle''); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) (''The step-transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form.''); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) (''By emphasizing substance over form, the step-transaction doctrine prevents a taxpayer from escaping taxation. The doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked.''); *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (''The step-transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.''); *Teong-Chan Gaw v. Commissioner*, T.C. Memo 1995-531 at 124 (''The step-transaction doctrine developed from the substance over form doctrine.'') (citing *Associated Wholesale Grocers*, 927 F.2d at 1521).

[22] *See, e.g., MAS One Ltd. P'ship v. United States*, 271 F. Supp. 2d 1061, 1067 (S.D. Ohio 2003), *aff'd*, 390 F.3d 427 (6th Cir. 2004) (''The step-transaction doctrine is inapplicable to this case because the substance and the form of the transactions in question do not differ in any meaningful way.''); *Turner Broad. Sys., Inc. v. Commissioner*, 111 T.C. 315, 326 (1998) (''in order to apply either the substance-over-form doctrine or the step-transaction doctrine, we must determine that the substance of the transaction differs from its form.'').

[23] ''The courts have examined the parties' intent at the beginning of the transaction as to the end result. The relevant intent is the parties' ''actual'' intent rather than their ''constructive,'' ''putative'' or ''hypothetical'' intent.'' Rothman, Capps, Herzog and Brady, 758 T.M., *Transfers to Controlled Corporations: In General*, at III.F.2.a.(1).

[24] ''The courts traditionally consider relevant the length of time that lapses between the transactions. The fact that two transactions occur simultaneously or are separated by short intervals suggests that each transaction is part of one larger transaction. However, depending on the circumstances, this factor may be given little weight. Transactions separated by several years have been integrated, while others separated by less than an hour have not.'' Rothman, Capps, Herzog and Brady, 758 T.M., *Transfers to Controlled Corporations: In General*, at III.F.2.a.(2).

[25] ''Perhaps the single most important factor in determining the applicability of the step-transaction doctrine is whether the transactions are so interdependent that none of the transactions would have been effected without the others. The courts have held that, when two or more transactions are intended and each transaction is planned before the first is consummated, the transactions may not be integrated if each transaction has substance by itself and has its own separate business purpose. If, however, the latter transactions are the sine qua non of the former, the courts will treat the individual transactions as one transaction. Also, if there is a binding commitment to undertake the second transaction at the time of the first transaction, even if the steps are mutually independent the transactions may be stepped together under the binding commitment test.'' Rothman, Capps, Herzog and Brady, 758 T.M., *Transfers to Controlled Corporations: In General*, at III.F.2.a.(3).

[26] Reg. §1.351-1(c)(5).

[27] *Id.*

[28] *Id.* Based on an example in the regulations, ''insignificant'' means 1% or less: ''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

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plan that 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.[29]

Diversification Test

Reg. §1.351-1(c)(6)(i) sets forth the diversification test for determining whether a transfer of property will be treated as a transfer to an ''investment company.'' Under this test, 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% tests of §368(a)(2)(F)(ii), applying the relevant provisions of §368(a)(2)(F).[30] The diversification test is a two-pronged test, which is satisfied if (1) not more than 25% of the value of the total assets transferred is invested in the stock and securities of any one issuer, and (2) not more than 50% of the value of the total assets transferred is invested in the stock and securities of five or fewer issuers.[31] All members of a controlled group of corporations (within the meaning of §1563(a)) are treated as one issuer.[32] Cash and cash items (including receivables) are excluded in determining total assets.[33] Government securities are included in total assets for purposes of the denominator of the 25% and 50% tests (unless the Government securities are acquired to meet the 25% and 50% tests), but are not treated as securities of an issuer for purposes of the numerator of the 25% and 50% tests.[34] The term ''Government securities'' appears to refer to United States Government securities.[35] For purposes of §368(a)(2)(F), the term ''securities'' includes obligations of State and local governments, commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the 1940 Act. The IRS has issued private letter rulings in the context of master/feeder structures that a transfer solely of cash by some investors and a diversified portfolio of securities by others does not taint the tax-free nature of the in-kind transfers occurring as part of the same plan. While the reasoning is unstated, it appears to be because the separate account securities being transferred in kind are already diversified and any cash being contributed will be invested in securities consistent with the fund's investment objective and policies or held for operational reasons.[36]

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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.'' Reg. §1.351-1(c)(7) *Ex.* 1.

[29] Reg. §1.351-1(c)(5). A transaction resulting in diversification constitutes a transfer to an investment company and thus is not a tax-free transaction under §351.

[30] Reg. §1.351-1(c)(6)(i).

[31] §368(a)(2)(F)(ii). The Department of the Treasury has included the issuance of ''Regulations under §351(e) and §362(a)(2)(F) [sic] regarding investment company issues'' as part of its 2015-2016 Priority Guidance Plan. Department of the Treasury, Second Quarter Update to 2015–2016 Priority Guidance Plan (Feb. 6, 2016), at p. 3.

[32] *Id.*

[33] §368(a)(2)(F)(iv).

[34] Reg. §1.351-1(c)(6)(i).

[35] Numerous IRS private letter rulings contain a representation that ''U.S. Government securities are excluded'' in determining total assets. PLR 8910018, PLR 8940007, PLR 9045023, PLR 9045043, PLR 9050015, PLR 9125028, PLR 9103017, PLR 9240016, PLR 9309036, PLR 9426033, PLR 9510004, PLR 9510013, PLR 9602009, PLR 9602024, PLR 200047023, PLR 200132010. Issues sometimes arise regarding whether Fannie Mae or Freddie Mac securities are government securities for purposes of §368(a)(2)(F). There does not appear to be any direct authority addressing this issue. For purposes of the RIC asset diversification test under §851 (the ''RIC ADT''), the IRS has issued Rev. Rul. 92-89, 1992-2 C.B. 154, which identifies certain stock and debt obligations as ''Government securities'' for purposes of the RIC ADT. The revenue ruling identifies (i) Freddie Mac ''Mortgage participation certificates and Stock''; (ii) Fannie Mae ''Fully modified passthrough mortgage-backed certificates and Stock''; and (iii) Ginnie Mae ''Fully modified passthrough mortgage-backed certificates'' as government securities. Securities and Exchange Commission correspondence also indicates that obligations of the Federal National Mortgage Association ('FNMA'), Federal Home Loan Banks ('FHLB') and Federal Land Banks ('FLB') are considered ''government securities' under the provisions of the 1940 Act. Letter to John W. S. Littleton, Director of the Income Tax Division of the Internal Revenue Service from Alan Rosenblatt, Chief Counsel, Division of Corporate Regulation, SEC (Apr. 6, 1971) and Letter to Federal Home Loan Mortgage Corporation from Alan Rosenblatt, Chief Counsel, Division of Corporate Regulation, SEC (June 23, 1971). In the 1940 Act SEC Release, *Final Rule: Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate*, the SEC states that ''[g]overnment securities may be issued by government-sponsored enterprises (''GSEs'') such as the Federal National Mortgage Association (''FNMA'') and by government corporations such as the Federal Deposit Insurance Corporation.'' The SEC cites *The Handbook of Fixed Income Securities*, a book written by Frank J. Fabozzi. *See* Frank J. Fabozzi and Michael J. Fleming, *U.S. Treasury and Agency Securities in The Handbook of Fixed Income Securities* 175, 191–96 (Frank J. Fabozzi, ed., 2001) (discussing ''agency'' securities issuers, including GSEs and government corporation issuers).

[36] For example, PLR 200118041 (a master/feeder ruling) includes the following representation: ''FeederFund1, FeederFund2, and any other transferor who contributes assets to the Trust will transfer solely cash or a diversified portfolio of assets in exchange for an interest in Trust.'' PLR 200113015 contains a factual statement that ''cash contributed by Feeder Funds has been and will be used only to carry on the normal operating and investment ac-

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TAX CONSEQUENCES OF TAX-FREE EXCHANGE

As described above, as part of the tax-free §351 transaction, the transferor partnership transfers a diversified portfolio of securities to a corporation that intends to elect and qualify to be taxed as a RIC for federal income tax purposes. In exchange for the transfer of its portfolio securities, the RIC transfers its shares to the transferor partnership and that partnership typically distributes such shares to its partners pro rata in proportion to each partner's interest in the partnership. As promptly as reasonably practical after such transfer, the partnership normally dissolves pursuant to state law and pursuant to the terms of the limited partnership agreement or limited liability company agreement governing the entity. Generally, liquidating distributions of a partnership do not result in gain or loss to the partners in the partnership unless the partners receive ''money'' in excess of their basis.[37] Distributions of ''marketable securities'' are treated as distributions of ''money.''[38] RIC shares generally are treated as ''marketable securities.''[39] However, RIC shares are treated as a distribution of ''marketable securities'' to a partner if the partners are ''eligible partners'' (i.e., they contributed only property that an ''investment partnership'' can hold), the liquidating partnership is an ''investment partnership,'' and the partners receive only RIC shares and no other money. An ''investment partnership'' is defined as any partnership which has never been engaged in a trade or business and substantially all the assets of which have always 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.[40] Assuming that the partners in the transferor partnership are ''eligible partners,'' the basis of the RIC shares distributed by the transferor partnership to a partner in liquidation of such partner's interest in the partnership is an amount equal to the adjusted basis of such partner's interest in the partnership (reduced by any money distributed in the same transaction).[41] The holding period of the RIC shares received, or constructively received, by the transferor partnership includes the holding period of the assets that were transferred by such partnership to the RIC (provided that the assets were held by the transferor partnership as capital assets on the date of transfer).[42] The holding period of the RIC shares in the hands of a partner of the transferor partnership includes the periods during which the RIC shares were held by transferor partnership (which includes the periods during which assets transferred by the transferor partnership to the RIC were held by the transferor partnership).[43]

The tax basis of the portfolio securities of the transferor partnership received by the RIC is the same as the tax basis of such assets in the hands of the transferor partnership immediately before the transfer.[44] The holding period of the assets of transferor partnership in the hands of the RIC includes the periods during which such assets were held by transferor partnership.[45]

INFORMATION REPORTING

Applicable Treasury regulations require every ''significant transferor'' that participates in a §351 transaction to include a statement titled, ''STATEMENT PURSUANT TO §1.351-3(a) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT TRANSFEROR,'' on or with the transferor's income tax return for the tax year of the §351 exchange.[46] A significant transferor is a person that transferred property to a corporation and received stock of the transferee corporation in a §351 exchange if, immediately after the exchange, the person: (1) owned at least 5% (by vote or value) of the total outstanding stock of the transferee corporation if the stock owned by such person is publicly traded, or (2) owned at least 1% (by vote or value) of the total outstanding stock of the transferee corporation if the stock owned by such per-

tivities of each respective Series).'' Contrary authority, Rev. Rul. 87-9, 1987-1 C.B. 133, indicates that a contribution of cash is problematic (contribution of cash and Y stock to newly formed X results in diversification of transferor of Y stock). However, as Susan Johnston notes in her treatise, *Taxation of Regulated Investment Companies and Their Shareholders (WG&L)*, ¶6.04 at n. 110, ''Rev. Rul. 87-9, 1987-1 C.B. 133 (the transfer by several individuals of stock in a single company to newly formed RIC in exchange for 89 percent of the RIC's shares caused transferors' interests to become diversified under §351, where public purchased remaining 11 percent of the shares for cash). The IRS relented on its position with respect to previously diversified portfolios when it adopted Treas. Reg. §1.351-1(c)(6).''

[37] §731(a).

[38] §731(c).

[39] §731(c)(2)(B)(i)(II).

[40] §731(c)(3)(C)(i). In a master-feeder context, a taxpayer looks through the lower-tier ''investment partnerships'' to satisfy the asset holding requirement of §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. Reg. §1.731-2(e)(4).

[41] §732(b).

[42] §1223(1).

[43] §735(b).

[44] §362(a). Subject to the application of the built-in loss rules discussed below.

[45] §1223(2).

[46] Reg. §1.351-3(a).

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son is not publicly traded.[47] Publicly traded stock for this purpose means stock that is listed on a national securities exchange registered under §6 of the Securities Exchange Act of 1934 or an interdealer quotation system sponsored by a national securities association registered under §15A of the Securities Exchange Act of 1934.[48]

APPLICATION OF BUILT-IN GAIN RULES

If a private fund is converted to a RIC, it is possible that the RIC could be subject to tax at the RIC level pursuant to regulations under §337. Reg. §1.337(d)-7(a)(1) states, in part, that ''[i]f property owned by a C corporation . . . becomes the property of a RIC or a real estate investment trust [(''REIT'')] (the converted property) in a conversion transaction . . . , then §1374 treatment will apply . . . unless the C corporation elects deemed sale treatment with respect to the conversion transaction.'' Under this rule, the RIC (or the REIT) is subject to tax on the net built-in gain in the converted property, generally, under the rules of §1374.[49] For purposes of this rule, a C corporation generally is defined to mean a corporation that is not an S corporation, but does not include a RIC or a REIT.[50] A conversion transaction is defined to include the qualification of a C corporation as a RIC or a REIT or the transfer of property owned by a C corporation to a RIC or a REIT.[51] In the context of a conversion of a private fund to a RIC whereby the private fund transfers its portfolio securities to a corporation that intends to elect and qualify to be taxed as a RIC, it is the latter part of the definition of a conversion transaction that could subject the RIC to tax at the RIC level.[52]

The recognized built-in gains and losses of a RIC are included in computing investment company taxable income for purposes of §852(b)(2) (describing the investment company taxable income of a RIC), capital gains for purposes of §852(b)(3) (describing capital gains of a RIC), gross income derived from sources within any foreign country or possession of the United States for purposes of §853 (describing the foreign tax credit allowed to shareholders of a RIC), and the dividends paid deduction for purposes of §852(b)(2)(D) (describing an adjustment to investment company taxable income for the dividends paid deduction) and §852(b)(3)(A) (describing an adjustment to a RIC's capital gains for the dividends paid deduction).[53] In computing such income and deduction items, capital loss carryforwards and net operating loss carryforwards that are used by the RIC to reduce recognized built-in gains are allowed as a deduction, but only to the extent that they are otherwise allowable as a deduction against such income under the Code.[54] The amount of tax imposed on the net recognized built-in gains for a tax year is treated as a loss sustained by the RIC during such tax year.[55] The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gains) among the items of recognized built-in gains included in net recognized built-in gains.[56] With respect to RICs, the tax imposed on net recognized

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[47] Reg. §1.351-3(d)(1).

[48] Reg. §1.351-3(d)(2).

[49] Reg. §1.337(d)-7(b)(1)(i). When a C corporation converts to an S corporation or an S corporation acquires assets from a C corporation in a tax-free transaction, the S corporation might be subject to a corporate-level ''built-in gains'' tax. This tax is in addition to the tax imposed on its shareholders. The C corporation must determine whether it has a net unrealized built-in gain in its assets on the effective date of the conversion transaction. If it does, the S corporation must track its dispositions of these assets for the next five years. Built-in gains recognized during this period are taxed at the highest rate of tax applicable to corporations (currently 35%). The recently enacted Protecting Americans From Tax Hikes Act of 2015 (''PATH Act'') shortened the recognition period for built-in gains from 10 years to five years. The Conference Report to the PATH Act confirms that this shortened recognition period applies to RICs and REITs as well. It states, in part, that:

> A regulated investment company (''RIC'') or a real estate investment trust (''REIT'') that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of §1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects 'deemed sale' treatment. [citing Reg. §1.337(d)-7(b)(1)(i) and (c)(1).] The regulations include an express reference to the 10-year recognition period in §1374. . . [citing Reg. §1.337(d)-7(b)(1)(ii).] The provision makes the rules applicable to taxable years beginning in 2012, 2013, and 2014 permanent [i.e., for taxable years beginning in 2012, 2013, and 2014, the term ''recognition period'' in §1374, for purposes of determining the net recognized built-in gain, was applied by substituting a five-year period for the otherwise applicable 10-year period].
>
> Under current Treasury regulations, these rules, including the five-year recognition period, also would apply to REITs and RICs that do not elect 'deemed sale' treatment. The provision is effective for taxable years beginning after December 31, 2014.

[50] Reg. §1.337(d)-7(a)(2)(i).

[51] Reg. §1.337(d)-7(a)(2)(ii).

[52] At a minimum, it would be unusual for an entity taxed as a RIC to be subject to tax at the RIC level. The application of the built-in gain tax at the RIC level would be a disclosure issue in the RIC's registration statement and could make the RIC unattractive to potential investors.

[53] Reg. §1.337(d)-7(b)(3)(i).

[54] *Id.*

[55] Reg. §1.337(d)-7(b)(3)(ii).

[56] *Id.*

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built-in gains is treated as attributable to the portion of the RIC's tax year occurring after October 31.[57]

The built-in gain regulations contain a special rule for partnerships. Under this rule, one must look through the partnership to determine whether any of the partners in the partnership are taxed as C corporations.[58] An example in the regulations indicates that not only a traditional C corporation partner of the transferor partnership could cause the RIC to the subject to the built-in gains tax, but also a tax-exempt entity partner (including, but not limited to, a §501(c)(3) organization, a qualified plan under §401(a), a charitable remainder annuity trust, a charitable remainder unitrust, a §529 plan or an instrumentality of a government) subject to the unrelated business income tax with respect to its investment in the transferor partnership.[59] This special rule for partnerships requires the transferor partnership to look through its nominal owners and determine the identity of its beneficial owners to determine whether any of them are C corporations for purposes of the possible application of the built-in gains tax to the RIC.

The regulations call off the application of the built-in gains tax if a deemed sale election is made by the transferor partnership or by the C corporation partners of such partnership.[60] If the election is made, the C corporation partner of the transferor partnership recognizes gain and loss as if the converted property were sold to an unrelated party at fair market value on the day before the day of the transfer by the transferor partnership of its portfolio securities to the RIC.[61] If a net gain is recognized, then the converted property has a basis in the hands of the RIC equal to the fair market value of the converted property on the deemed sale date.[62] Either the C corporation partner (or the transferor partnership) can make the deemed sale election.[63] The election is made by attaching a plain paper statement to the federal income tax return of the C corporation partner or the partnership for the tax year in which the deemed sale occurs.[64] The statement must read as follows:

> [Insert name and employer identification number of electing corporation or partnership] elects deemed sale treatment under §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 employer identification number of the RIC or REIT, if different from the name and employer identification number of the C corporation or partnership].[65]

The deemed sale election is irrevocable once made.[66] If the transferor partnership were to make the deemed sale election, then any net gain recognized by the partnership on the deemed sale is allocated to the C corporation partner, but such gain does not increase the capital account of any partner.[67] Additionally, any adjustment to the transferor partnership's basis in the RIC shares resulting from the deemed sale election constitutes an adjustment to the basis of those shares with respect to the C corporation partner only.[68]

APPLICATION OF BUILT-IN LOSS RULES

Section 362(e) is an exception to the general rule that the basis of property received by a corporation, such as a RIC, in certain tax-free transactions, such as a §351 exchange, is identical to the basis of the property in the hands of the transferor, such as the transferor partnership, adjusted to include any gain recognized by the transferor in connection with the transfer.[69] Section 362(e)(1) limits the importation of built-in losses. Generally, an importation of a net built-in loss occurs in a transaction if the transferee's aggregate adjusted bases of property which is transferred in a §351 exchange would exceed the fair market value of the property immediately after such transfer.[70] Section 362(e) applies when, for example, foreign-used property with an aggregate net built-in loss is transferred to a U.S. corporation (e.g., where a foreign hedge fund converts to a RIC).[71] It also applies to property with a net built-in loss held by a tax-exempt entity which is transferred to a RIC.[72] The carryover basis (i.e., the transferee RIC's basis) of all the transferred importation property is limited to the (lower) fair market value of the property if: (1) transferor is not subject to U.S. tax on disposition of the

[57] *Id.*

[58] Reg. §1.337(d)-7(e)(1).

[59] Reg. §1.337(d)-7(e)(2).

[60] Reg. §1.337(d)-7(c)(1). Depending on the circumstances of the conversion transaction, it might be important to include a representation and/or covenant in the plan of transfer that the deemed sale election will be made (backed by an indemnification obligation) so that the RIC has reasonable assurances that the election will be made and has recourse if the election is not made.

[61] Reg. §1.337(d)-7(c)(1) and §1.337(d)-7(c)(3).

[62] Reg. §1.337(d)-7(c)(2).

[63] Reg. §1.337(d)-7(c)(5).

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] Reg. §1.337(d)-7(e)(1).

[68] *Id.*

[69] The general rule is set forth in §362(a).

[70] §362(e)(1)(C).

[71] §362(e)(1)(B).

[72] *Id.*

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property before the transfer,[73] (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 fair market value of the property transferred.[74]

Section 362(e)(2) applies to limit the duplication of built-in losses. It applies to the transfer of all property with a built-in loss to a corporation (e.g. a private fund converting to a RIC).[75] The carryover basis of the loss properties that are transferred (i.e., the transferee RIC's basis) are written down to their fair market values if: (1) the property is transferred in a §351 transaction; and (2) the aggregated adjusted bases of the property transferred exceeds the aggregate fair market value of such property.[76] Section 362(e)(2) applies only to the extent that §362(e)(1) does not apply.[77] The §362(e)(2) adjustment is made on asset-by-asset basis for the loss properties (i.e., the built-in gain properties cannot be marked up).[78] Section 362(e)(2)(C) permits the transferor partnership and the RIC to make an irrevocable election that reduces the basis of the RIC shares received by a partner in the transferor partnership by the amount of the built-in loss in the transferred property received by the RIC. Such a reduction would be in lieu of a basis reduction in the assets transferred to the RIC.

NONPUBLICLY OFFERED RIC

Sometimes a private fund transfers its assets to a ''nonpublicly offered'' RIC. A nonpublicly offered RIC raises at least two federal income tax wrinkles — A special rule applies for determining the taxable income of a shareholder of a nonpublicly offered RIC (this is discussed below),[79] and the preferential dividend rule continues to apply to a nonpublicly offered RIC.[80]

A nonpublicly offered RIC is, quite simply, a RIC that is not a publicly offered RIC.[81] A publicly offered RIC is one the shares of which are: (1) continuously offered pursuant to a public offering (within the meaning of §4 of the 1933 Act), (2) regularly traded on an established securities market, or (3) held by or for no fewer than 500 persons at all times during the tax year.[82]

Generally, the importance of being a nonpublicly offered RIC is that shareholders in such a RIC that are individuals and certain trusts and estates are treated as having received or accrued as a dividend an amount equal to the investor's allocable share of certain of the RIC's expenses for the calendar year and as having paid or incurred as an expense described in §212 an amount equal to such investor's allocable share of the expenses of the nonpublicly offered RIC for the calendar year.[83] Therefore, the impact of the provision is to subject certain of the RIC's expenses to the 2%

[73] Section 362(e)(1)(B) and Prop. Reg. §1.362-3(d)(2) require a transferor partnership to look-through the partnership and determine whether any of its partners would not be subject to U.S. tax on disposition of the property before the transfer (e.g., possibly property held by a foreign person, property held by a tax-exempt organization and not subject to the unrelated business income tax, etc.). The Department of the Treasury has included the issuance of ''Final regulations under §362(e)(1) regarding the importation of losses'' as part of its 2015-2016 Priority Guidance Plan. Department of the Treasury, Second Quarter Update to 2015-2016 Priority Guidance Plan (Feb. 6, 2016) at p. 10.

[74] An example in the Proposed Regulations under §362 illustrates the application of this provision. Prop. Reg. §1.362-3(f) *Ex.* 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 §351 applies. But for §362(e)(1), F's basis in the importation property would be $50, which exceeds the $35 fair market value of Asset 1. The RIC's basis initially would be $85 (A's $50 plus F's $35) in the property; exceeding the $70 fair market value of Asset 1 (i.e., $15 built-in loss). Due to §362(e)(2) (discussed below), the RIC's basis in Asset 1 is $70 and pursuant to §358, P's basis in the RIC shares received is still $100.

[75] §362(e)(2)(A).

[76] *Id.* Note that the rules on built-in losses do not impact the basis of a partner's shares in the RIC shares that the partner receives from the transferor partnership.

[77] §362(e)(2)(A)(i).

[78] §362(e)(2)(B).

[79] §67(e).

[80] §562(c). The preferential dividend rule disallows a RIC from claiming a deduction for dividends paid. Section 852(b)(2)(D) allows a RIC to claim a deduction for dividends paid. Section 561 defines the deduction for dividends paid and applies the rules of §562 to determine which dividends are eligible for the deduction for dividends paid. Section 562(c) states that the amount of any distribution is not considered a dividend for purposes of computing the dividends paid deduction under §561 unless the distribution is pro rata, does not prefer any share of stock of a class over any other share of stock of that same class, and does not prefer one class of stock over another class except to the extent that one class is entitled (without reference to waivers of their rights by shareholders) to the preference.

[81] Reg. §1.67-2T(g)(3).

[82] A private fund that converts to a business trust that is a nonpublicly offered investment company (i.e., one whose shares are not continuously offered, one that is not regularly traded on an established securities market, and one held by or for fewer than, for example, 100 persons) that wishes to elect and qualify to be taxed as a RIC should file an election on IRS Form 8832 to be treated as an association taxable as a corporation. See the discussion above under ''The RIC as a Corporation.''

[83] Reg. §1.67-2T(e)(1)(ii) and §1.67-2T(h)(1). The amount of dividend income that an affected investor in a nonpublicly offered RIC is treated as having received or accrued under Reg. §1.67-2T(e)(1)(ii) is not subject to backup withholding under §3406. Reg. §1.67-2T(l). The amount described in this footnote is reported to shareholders of the nonpublicly offered RIC on Form 1099-DIV (''Dividends and Distributions''), Lines 1a (Total ordi-

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floor on miscellaneous itemized deductions, set forth in §67, at the shareholder level. Expenses that are deductible by the RIC include expenses paid or incurred for directors' or trustees' fees; meetings of directors, trustees, or shareholders; transfer agent fees; legal and accounting fees (other than fees for income tax return preparation or income tax advice); and shareholder communications required by law (e.g. the preparation and mailing of prospectuses and proxy statements).[84] Other expenses of the nonpublicly offered RIC likely are viewed as expenses related to the investment by the RIC's shareholders and thus are treated as a dividend to the RIC's shareholders and deductible, if at all, at the shareholder level.

A nonpublicly offered RIC can elect to treat the affected RIC expenses for a calendar year as equal to 40% of the aggregate amount of its expenses (other than losses from the sale or exchange of property and itemized deductions not subject to the 2% floor) paid or incurred in the calendar year that are allowable as a deduction in determining the investment company taxable income.[85] The election is made by the nonpublicly offered RIC attaching to its income tax return for the tax year that includes the last day of the first calendar year for which the nonpublicly offered RIC makes the election a plain paper statement indicating that it is making the election.[86] The election can be revoked only with IRS consent.[87]

Other Conversion Issues

ERISA Plan Assets

A private fund seeking to convert to a RIC might have as one or more of its partners employee benefit plans subject to Part 4 of Title I of ERISA.[88] In the context of a conversion of a private fund to a RIC, the general partner of the partnership or the managing member of a limited liability company taxed as a partnership, or an affiliate of same, also serves as the investment advisor to the RIC. In this case, if 25% or more of any class of interests in the private fund are held by benefit plan investors, and one or more of those benefit plan investors is a plan subject to ERISA, the transfer of those assets to the RIC on an in-kind basis raises issues under the prohibited transaction rules of §406 of ERISA and §4975 of the Code, and these issues may not be resolvable on a satisfactory basis without a Department of Labor exemption providing that the transaction is not a prohibited transaction.[89] The process with the Department of Labor normally takes four to eight months and would need to be built into the timing of the conversion. Alternatively, all or part of the ERISA plan investors' interests in the private fund could be converted to cash and then, such investors could contribute that cash to the RIC in exchange for RIC shares. The prohibited transaction rules do not prohibit this. As a practical matter, however, the ERISA plan assets will be uninvested for some period of time and/or there is a chance that the ERISA plans decide not to invest in the newly formed RIC.

Portability of Performance

The RIC which obtained assets from a private fund generally has three option with respect to reporting the performance of the RIC. Sometimes the RIC might want to adopt the performance of the private fund. In this case, the RIC would need to follow standards set forth in Securities and Exchange Commission (''SEC'') no-action letters. A 1995 SEC no-action letter requires the following conditions to be satisfied for the RIC to adopt the performance of the private fund: (1) the RIC has the same portfolio before and after the conversion; (2) the RIC has the same investment advisor as the private fund; (3) the RIC has the same investment objectives, policies, etc. as the private fund; (4) the private fund was not formed to establish a performance history; and (5) there is full disclosure that the private fund's performance history is included in the prospectus of the RIC.[90] If the RIC adopts the performance history of the private fund, such history appears in the fund summary of the prospectus and normally is accompanied by disclosure that ''Performance for periods prior to [DATE] reflects the performance of the predecessor fund.''

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nary dividends) and 5 (''Investment expenses''). The instructions to the 2015 Form 1099-DIV instruct, with respect to this line, the nonpublicly offered RIC to, ''Enter the recipient's *pro rata* share of certain amounts deductible by a nonpublicly offered RIC in computing its taxable income. This amount is includible in the recipient's gross income under §67(c) and must also be included in box 1a.''

[84] Reg. §1.67-2T(j).

[85] Reg. §1.67-2T(j)(2).

[86] *Id.*

[87] *Id.*

[88] Employee Retirement Income Security Act of 1974 (''ERISA'').

[89] This fact pattern implicates the self-dealing rules of §4975. Section 4975 imposes a tax on certain ''prohibited transactions'' at a rate of 15% of the amount involved with respect to the prohibited transaction and the tax is paid by any ''disqualified person'' who participates in the prohibited transaction. If the prohibited transaction is not corrected (meaning, if the transaction is not undone), the tax increases to 100% of the amount involved. The conversion of a private fund to RIC could be a prohibited transaction where, as described above, the general partner of the partnership or the managing member of a limited liability company taxed as a partnership also will serve as the investment advisor to the RIC.

[90] Massachusetts Mutual Life Insurance Co., SEC No-Action Letter (Sept. 28, 1995).

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Alternatively, the RIC might choose to report related performance. This also is based on standards set forth in SEC no-action letters.[91] In this case, the RIC is not adopting the performance of the private fund, but instead is presenting the private fund's performance as related performance in the back of the prospectus. Note that Financial Industry Regulatory Authority (''FINRA'') rules are more restrictive. Under such rules, the RIC is able to report related performance in sales literature presented to institutional investors and not in sales literature presented to retail investors.[92]

Finally, the RIC might decide to forgo reporting the prior performance of the private fund and instead report its performance from its inception. Adopting the performance of the private fund or reporting related performance is not required and is closely scrutinized by the SEC when the RIC chooses one of those options.

Conversion of a Common Trust Fund or a Group Trust to a RIC

Sometimes the converting entity is a 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, and not an entity taxed as a partnership for federal income tax purposes. A common trust fund is not a corporation for federal income tax purposes and is not subject to tax. [93] The conversion of a common trust fund into one or more RICs can be achieved on a tax-free basis (i.e., with no gain or loss to fund or the participants in the fund).[94] The transaction would still involve a §351 exchange whereby the common trust fund transfers its portfolio securities to one or more RICs solely in exchange for RIC shares. The transaction must satisfy the §351 requirements set forth above, including the diversification standard applicable to investment companies (i.e., the 25% and 50% tests described above). The common trust fund would then distribute the RIC shares to the common trust fund participants in exchange for their trust interests. The RIC takes a carryover basis in the common trust fund's portfolio securities, and the common trust fund participants take a basis in their RIC shares equal to the basis such participants had in their common trust interests.

In addition to partnerships and common trust funds converting to RICs, group trusts (i.e., so-called ''81-100 trusts'')[95] might wish to convert to RICs too.[96] A group trust is a collection of qualified retirement plans and individual retirement accounts. The group trust is exempt from tax under §501(a) (with respect to its funds that equitably belong to participating trusts described in §401(a)) and is exempt from taxation under §408(e) (with respect to its funds that equitably belong to individual retirement accounts that satisfy the requirements of §408). The conversion of a group trust to a RIC generally is accomplished to broaden the base of investors, as a group trust can include only other pension trusts as its investors. Similar to a conversion transaction involving a partnership or a common trust fund, a group trust that transfers its portfolio securities to a RIC and satisfies the requirements of a §351 exchange, including by transferring a diversified portfolio of securities to a RIC, can be accomplished on a tax-free basis. Because the group trust is tax-exempt, it would be beneficial, if possible, to structure the transaction as a taxable transaction if taxable investors will purchase shares in the new RIC. That way, the RIC's basis in the transferred portfolio securities of the group trust would equal the fair market value of such securities, which would be beneficial to taxable investors purchasing shares of the RIC, assuming that the transferred portfolio securities of the group trust are in a net built-in gain position.

Rolling Up Separate Accounts to a RIC

Finally, an adviser might have a number of separately managed accounts that it manages and desires to roll-up the assets of the accounts into a RIC on a tax-free basis. In order to accomplish this on a tax-free basis under §351, generally, the following steps should be taken:

- The roll-up date to transfer the separately managed account assets needs to be selected, and the transfers should occur pursuant to a plan of transfer so that all transfers in kind are linked.
- Separately managed account assets to be transferred to the RIC should be consistent with the RIC's investment objectives, policies and restrictions. Assets that would be inconsistent with the

[91] Nicholas-Applegate Mutual Funds, SEC No-Action Letter (Aug. 6, 1996).

[92] FINRA Interpretive Letter to Edward P. MacDonald, Hartford Funds Distributors, LLC (May 12, 2015).

[93] §584(b).

[94] §584(h).

[95] Referring to Rev. Rul. 81-100, 1981-1 C.B. 326.

[96] Similar prohibited transaction issues arise under §406 of ERISA and §4975 in connection with the conversion of a group trust to a RIC as in the case of conversion of a private funds to a RIC. The U.S. Department of Labor has issued a prohibited transaction class exemption that, depending upon the facts, might be available in connection with a conversion of a group trust to a RIC. PTCE 97-41, 62 Fed. Reg. 48,230 (Aug. 8, 1997). The ability to rely on this class exemption would eliminate the need to secure an individual exemption for the conversion transaction.

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RIC's investment objectives, policies, and restrictions could be held back and only a portion of the separately managed account assets transferred.

- Each transfer by a separately managed account holder should consist of a diversified portfolio of securities, meaning that the securities should satisfy the §368(a)(2)(F) 25% and 50% diversification tests discussed above.
- If a separately managed account is an ERISA account, then consideration must be given to the prohibited transaction rules discussed above and the possible need for a Department of Labor exemption or the application of other remedial measures.

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