Tax issues for business development companies

by Robert Meiner

In the first two articles of this three-part series on business development companies (BDCs), we examined the factors driving the current popularity BDCs enjoy as investment and funding vehicles. We also drilled down into the specific accounting and reporting requirements that these publicly traded entities must meet. In this, the final article in the series, we discuss the significant tax advantages a BDC can realize if it qualifies as a regulated investment company (RIC) under the Internal Revenue Code. To qualify, an entity must meet three broad requirements surrounding treatment of gross income, asset diversification and income distribution. In this article, we will examine these three requirements as part of the RIC tax regime and identify strategies for meeting them.

In the current economic and regulatory climate, BDCs are becoming popular not only as publicly available investments but as effective vehicles for funding capital-hungry businesses. BDCs also enjoy the benefit of simplified tax reporting requirements, are effective vehicles for funds using leverage and, when they qualify as RICs, may not be subject to corporate-level taxes.

In order to qualify as a RIC, a BDC must meet three primary requirements under Subchapter M of the Internal Revenue Code:

1. **Gross income.** Generally, at least 90% of the BDC’s annual gross income must be derived from dividends, interest, gains from the sale or exchange of securities and other “qualifying” income associated with the business of investing in securities. BDCs may generate other types of income, and in the context of RIC requirements, it can be questionable whether that income is considered qualifying income. Some of the categories of income that come into question are up-front commitment fees, underwriting fees and facilities fees, among others.
In answering this question, the important thing to remember is that if the fee is related to an investment and is truly part of the overall yield, it is more likely to meet the RIC requirement and can be categorized as “good income.” However, any fee related to a service would be considered “bad income.” For example, if a BDC is a lead underwriter and earns a disproportionate underwriting fee, that fee would be categorized as bad income.

Typically, a BDC generates more non-qualifying income in its first year of operations. During this time, it may not be generating much coupon income, original issue discount income or other income that would qualify, so the non-qualifying income component could be substantial and should be closely monitored. As a best practice, a BDC should use its legal counsel and tax advisers to examine the terms of every deal, because the tax liability at the BDC level could be significant if the components of income do not meet the requirements of the gross income test.

2. **Quarterly asset diversification.** At the end of each tax quarter, at least 50% of a BDC’s assets must be invested in cash items, securities of other RICs, government securities or other securities (provided its investment in any one security does not exceed 5% of the BDC’s total assets).

Furthermore, a BDC cannot own more than 10% of the voting stock of any one issuer and cannot invest more than 25% of the total value of its assets in 1) any one issuer (other than US government securities and other RICs); 2) any two or more issuers controlled by the BDC and engaged in the same or similar businesses; or 3) one or more “qualified publicly traded partnerships.” This is important – particularly during the start-up period – because in its first quarter, a BDC might make only one or two investments. Depending on when operations commence, a BDC might initially encounter problems meeting diversification requirements.

To address this challenge during the start-up period, BDC managers should seek counsel from tax advisers to identify and consider all potential available strategies and ramifications.
BDCs must also carefully review their investments in partnerships. Investing in the debt of a partnership is not an issue, but actually owning equity or possibly the right to acquire equity in one is another matter. The Internal Revenue Code requires that RICs take a “look through” approach, which means that they are deemed to own anything that the partnership owns. To meet the 50% asset diversification rule, it is feasible that a BDC would need to achieve complete transparency, which may be difficult to do given the structures of some partnerships. Furthermore, if the partnership owns investments in operating companies, these would be considered non-qualifying assets and the associated income would be non-qualifying.

Some BDCs hold debt investments in limited partnerships with warrant “kickers.” When calculating the necessary diversification levels for RIC qualification, the BDC must be cognizant of the ramifications of exercising those warrants. One strategy is to place them in some type of blocker entity, a domestic corporation or a controlled foreign corporation, to help mitigate the effect of these types of investments, and enable the BDC to treat them as qualifying assets.

3. Distributions. To qualify as a RIC, a BDC must distribute at least 90% of its annual investment company taxable income, which is defined as ordinary income plus short-term capital gains. Long-term capital gains do not necessarily need to be distributed in order to meet the qualification, but the BDC is taxed at the corporate rate for any long-term capital gains that are not distributed. In practice, most BDCs make the applicable distributions to avoid the corporate-level taxes. Additionally, BDCs must be aware of a tax regime called the “excise tax rules.” These rules require entities to make distributions on a calendar basis irrespective of when their tax years end.

BDCs must manage their cash carefully to cover distribution requirements in a timely manner. For example, entities will commonly generate some non-cash income through original issue discounts, market discounts or payments-in-kind. This income must be included for distribution purposes; but unless the entity plans ahead, it may not have the cash on hand to make the required distributions. One strategy for meeting the distribution requirements is to establish a robust dividend reinvestment plan so that the BDC does not lose these assets.

One final – and vital – point with respect to the RIC tax regime: the concept of writing down securities generally does not exist from a tax perspective. If a BDC owns a security in registered form (most of the investments held) for tax purposes, it is either worth something or worth nothing. Entities cannot take partial write-downs when calculating their taxable incomes. This treatment may differ from the GAAP treatment where partial write-offs may be taken, thus creating a book/tax difference which would need to be tracked and taken into account when setting the fund’s distributions.

Final thoughts
In meeting the income, diversification and distribution requirements needed to qualify for the tax advantages available to RICs, BDC managers and accountants must comply with the numerous rules of Subchapter M of the Internal Revenue Code. Of these, none is more important (and occasionally challenging) than the proper classification of good and bad income. Management and their tax advisers experienced in this area should regularly review the entity’s income classification procedures to guard against errors that could result in the painful loss of a valued tax advantage.
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