

# Converting Private Funds To Registered Funds

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In this article, Gray examines conversions of private funds into registered investment funds and their income tax consequences.

Those in the investment fund industry have noticed a trend over the past few years: the increased conversions of private funds into registered investment funds. These conversions can be complicated, and the subsequent tax compliance requirements of being a registered fund can be much more burdensome than those imposed on a private fund. This article addresses the types of funds involved, what's driving these conversions, and some of the federal income tax consequences of the conversions.

### I. Private Funds

A fund is generally considered an entity used to pool money from various investors. A private fund is structured to avoid registration as an investment company under the Investment Company Act of 1940 (the 1940 act) and will qualify for one of the following three exceptions:

- a 15 U.S.C. section 80a-3(c)(1) fund in which the fund has no more than 100 beneficial owners;
- a 15 U.S.C. section 80a-3(c)(7) fund, which is limited to qualified purchasers; and
- a 15 U.S.C. section 80a-3(c)(1) qualifying venture capital fund, which is not beneficially owned by more than 250

persons and not more than \$12 million in aggregate capital contributions and uncalled committed capital.

In the private fund world, these funds are typically treated as partnerships for federal income tax purposes.<sup>1</sup> The partnership will be formed as either a limited partnership or a limited liability company, with the fund sponsor (or an affiliate) acting as the general partner or managing member, as applicable. The fund's investment decisions will generally be made by an investment manager that will also be affiliated with the sponsor.

Since a private fund is a partnership, investors become partners in that partnership, and the partnership is governed by its partnership agreement. The partnership agreement dictates the investor's distributive share of partnership income, gain, loss, deduction, or credit; the amount, if any, of distributions to which an investor is entitled; and when and how an investor may dispose of its interest in the partnership. A typical hedge fund partnership agreement will base allocations on the beginning and ending net asset value of the fund attributable to the investor's interest, will not provide for cash distributions, and will only allow for disposition of interests (redemptions) under certain circumstances or at certain times. In addition to fees a private fund may pay to the investment manager, the general partner may be entitled to a carried interest.

<sup>1</sup> Note that references to "partnerships" include general partnerships, limited partnerships, and limited liability companies with more than one owner that have not elected to be treated as corporations for federal income tax purposes.

## II. Registered Funds

For purposes of this article, only registered funds treated as regulated investment companies under the code will be discussed. If a fund registers, or in the case of a business development company, elects to be regulated under the 1940 act, it will become subject to a host of federal compliance requirements. These include:

- having at least 40 percent of the directors be independent, or in the case of a business development company, a majority of the directors be independent;<sup>2</sup>
- having the initial board of directors elected by the shareholders;<sup>3</sup>
- being subject to limitations on the issuance of senior securities, borrowing, and other forms of capital structure leverage;<sup>4</sup>
- maintaining a fidelity bond against larceny and embezzlement;<sup>5</sup>
- prohibitions on certain affiliated transactions, such as principal transactions and joint transactions;<sup>6</sup>
- adopting a written code of ethics to prevent conflicts of interest that can arise when investment company personnel trade for their own accounts;<sup>7</sup>
- meeting certain recordkeeping requirements; and
- filing reports with the SEC and transmitting reports to shareholders.

Registered funds are typically formed as Delaware statutory trusts or as Maryland corporations and structured as either mutual funds, exchange-traded funds, registered closed-end funds, or business development companies. Mutual funds and ETFs are both open-end funds, which continuously offer their shares for sale and issue redeemable securities. ETFs, through SEC exemptive relief or Rule 6c-11, limit redemptions to large blocks of shares (each block of shares may

<sup>2</sup> 15 U.S.C. section 80a-10(a). Most registered funds have boards that are comprised of a majority of independent directors to rely on certain exemptive rules adopted under the 1940 act.

<sup>3</sup> 15 U.S.C. section 80a-16(a).

<sup>4</sup> 15 U.S.C. section 80a-18.

<sup>5</sup> 17 C.F.R. section 270.17g-1.

<sup>6</sup> 15 U.S.C. section 80a-17.

<sup>7</sup> 17 C.F.R. section 270.17j-1(c).

be called a “creation unit”) and only by authorized participants that have entered into agreements with the fund’s distributor.<sup>8</sup> ETF shares trade on a stock exchange and may be bought or sold at market prices on an exchange during a trading day. Mutual fund shares are purchased or redeemed directly through the fund at that fund’s net asset value determined at the end of the business day.

Closed-end funds include those registered under the 1940 act and business development companies that elect to be regulated under the 1940 act.<sup>9</sup> Because closed-end funds are not permitted to issue redeemable securities (that is, shareholders do not have a right to redeem at net asset value), closed-end funds are further classified by the manner in which liquidity is provided to investors: (1) traditional closed-end funds list their shares on an exchange and (2) interval funds are required to periodically (at least annually but typically quarterly) offer to repurchase at net asset value between 5 percent and 25 percent of their outstanding shares, and tender offer funds may, but are not required to, repurchase shares through periodic self-tender offers.

## III. Tax Consequences of Investing in Funds

### A. Private Funds

As a partnership, the private fund will not itself pay federal income tax on its taxable income, but will instead pass through its taxable income to its investors. The partnership will report each investor’s distributive share of partnership income, gain, loss, deduction, or credit on the investor’s Schedule K-1. Depending on the fund’s

<sup>8</sup> Before 2019 ETFs relied on exemptive orders, which permitted them to operate as investment companies under the 1940 act, subject to certain representations and conditions. The SEC adopted Rule 6c-11 under the 1940 act, which became effective December 23, 2019, permitting ETFs that satisfy certain conditions to operate without the expense and delay of obtaining an exemptive order from the SEC under the 1940 act. Under the rule, ETFs will be considered to issue a redeemable security within the meaning of section 2(a)(32) of the 1940 act even though its shares cannot be redeemed, except in limited circumstances, other than in creation unit aggregations. The rule also permits secondary market trading of the ETF’s shares at market-determined prices, allows for certain affiliated transactions, and permits the delay of the delivery of certain redemption proceeds.

<sup>9</sup> Business development companies are required to invest 70 percent of their assets in eligible portfolio companies, which are generally small U.S. companies.

activities, the investor may have state or local income tax reporting requirements. For instance, if the fund is originating loans and that activity is treated as a trade or business for income tax purposes, then an investor would potentially have income sourced to the state in which the fund has a taxable presence regarding the loan origination business. This reporting nexus could also occur when the fund invests in a lower-tier partnership that has its own trade or business and its activities are attributable to the fund and its investors.

For non-U.S. and tax-exempt investors, the fund's activities could present their own tax reporting and tax liability issues. For nonresident alien individuals and foreign corporate investors, the partnership's activities are attributable to them.<sup>10</sup> As a result, if the fund has income that is effectively connected with a U.S. trade or business, these investors would incur U.S. federal income tax on their allocable share of the partnership's taxable income attributable to those activities,<sup>11</sup> be subject to a withholding tax regarding both its allocable share of the ECI<sup>12</sup> and proceeds from the disposition of its interest,<sup>13</sup> and be required to file a U.S. federal income tax return regarding that income.<sup>14</sup>

Most tax-exempt investors will be concerned about unrelated business taxable income,<sup>15</sup> which can be derived from an underlying trade or business of the fund (or its investment in a lower-tier partnership) or from leverage used by the fund in an investment.<sup>16</sup> As a result, most private funds will establish feeder funds that are treated as corporations for U.S. federal income tax purposes. These feeder funds, or blockers, serve as the investment vehicles for non-U.S. and tax-exempt investors, so the fund's activities are not attributable to the feeder fund investors, and the

feeder fund bears the direct burden of the U.S. income tax consequences of the investment activity.

## B. Registered Funds

As further described below in Section VI, a registered fund needs to meet the specific requirements of the code and the underlying Treasury regulations in order to be treated as a RIC and, except as provided below, avoid corporate-level taxes (the RIC rules).<sup>17</sup> As a RIC, items of income, gain, loss, deduction, and credit do not pass through to investors in the same manner as in a private fund. A RIC generally avoids taxation on its taxable income to the extent it distributes to its shareholders amounts that are attributable to that income.

The code imposes a corporate-level tax on a RIC regarding its investment company taxable income (ICTI).<sup>18</sup> ICTI is the taxable income of the RIC with various adjustments, including excluding any net capital gain and allowing for the deduction for dividends paid (as defined in section 561), but this deduction is computed without regard to capital gain dividends and exempt-interest dividends.<sup>19</sup> A RIC should therefore not incur any federal income tax liabilities on its taxable income to the extent it timely distributes to its investors all its ICTI and net capital gain.

Unlike a private fund that provides an investor with a Schedule K-1, a RIC's distributions are reported to an investor on a Form 1099 and are generally classified as ordinary dividends. This results in short-term capital gains and interest income being distributed as ordinary dividend income.<sup>20</sup> A RIC can classify distributions into different categories, including distributions

<sup>10</sup> Section 875(1). If the foreign investor is eligible for benefits of an income tax treaty with the United States, the partnership would need a permanent establishment to create nexus with the United States.

<sup>11</sup> Sections 871(b) and 882(a).

<sup>12</sup> Section 1446(a).

<sup>13</sup> Section 1446(f).

<sup>14</sup> Section 6012(a)(1)(A) and 6012(a)(2). Note that non-U.S. investors, as well as any non-U.S. funds (or non-U.S. blockers) could also be subject to the Foreign Account Tax Compliance Act.

<sup>15</sup> Section 512(a)(1).

<sup>16</sup> Section 514(a).

<sup>17</sup> Sections 851-855.

<sup>18</sup> Section 852(b)(1).

<sup>19</sup> Section 852(b)(2). Since net capital gain is excluded from ICTI, including capital gain dividends — which are distributions of net capital gain — in the deduction for dividends paid, it would result in a double deduction of net capital gain from ICTI.

<sup>20</sup> See the discussion below regarding classification of interest and short-term capital gains for withholding purposes regarding non-U.S. investors.

attributable to (1) net capital gain as capital gain dividends treated as long-term gain in the investor's hands,<sup>21</sup> (2) income derived from qualified dividend income as qualified dividends,<sup>22</sup> and (3) dividends attributable to a real estate investment trust that is not a capital gain dividend or qualified dividend income as a section 199A dividend. In addition, corporate investors are only able to claim the dividend received deduction regarding RIC dividends received to the extent the amounts would be deductible by the RIC if it were taxed as a corporation.<sup>23</sup> Unlike a private fund, a RIC functions as a quasi-passthrough entity that avoids taxation by making distributions of its taxable income, while a private fund is generally never subject to federal income tax on its taxable income, and its investors are subject to income tax on their distributive share of the private fund's taxable income, whether any distributions are ever made.

#### IV. Why Convert?

If a fund is successful as a private fund, why would it convert to a registered fund and face the host of all the legal and tax compliance burdens imposed on a registered fund? The simple answer: increased fundraising opportunities through access to broader distribution channels. Although the cost of compliance with the new legal and tax rules will become much more burdensome, the expectation would be that by having access to new retail investors, a registered fund will have a much easier time finding investors and raising new capital as compared to a private fund because it is not limited by the number of investors (100 investors if relying on section 3(c)(1) or the type of investor (limited to qualified purchasers if relying on section 3(c)(7)). In addition to simplifying the process of raising capital, investors' tax reporting obligations become much less burdensome.

As described above, an investor in a private fund taxed as a partnership receives a Schedule K-1 for a tax year, which reports the investor's

allocable share of the fund's taxable income and any cash distributions. A disposition of an interest in a private fund can result in some of the gain attributable to the sale being converted into ordinary income.<sup>24</sup> The investor may also have a variety of potential state and local tax reporting exposures because of its interest in the fund. To the extent that the private fund has interests that are either traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), that fund will be treated as a publicly traded partnership.<sup>25</sup> A publicly traded partnership will be taxed as a corporation unless 90 percent of its gross income for the tax year consists of qualifying income.<sup>26</sup> An investor in a publicly traded partnership that is treated as a partnership for federal income tax purposes will receive a Schedule K-1 and face the same tax reporting issues as an investor in a private fund that is not publicly traded.

Alternatively, an investor in a RIC receives a Form 1099 regarding its share of the RIC's income. This income is typically sourced to the investor's state of residence so that the investor does not have to worry about tax nexus with other states attributable to its investment in the RIC. Disposing of an interest in a RIC is also much more straightforward, generally resulting in capital gain, which is also sourced to the investor's state of residence.

For tax-exempt and non-U.S. investors, investing in a RIC is also much more straightforward than investing in a private fund. A RIC is a corporation for U.S. federal income tax purposes that makes a special election to be treated as a RIC. As a corporation, it acts as its own blocker. Because a RIC acts as a blocker, a tax-exempt investor's receipt of dividends, including capital gain dividends, from the RIC is generally excluded from UBTI,<sup>27</sup> assuming the tax-exempt investor hasn't borrowed to make its investment.

<sup>21</sup> Section 852(b)(3)(B) and (C).

<sup>22</sup> Sections 1(h)(11)(B) and 854(b)(1)(B).

<sup>23</sup> Section 854(b)(1)(C).

<sup>24</sup> Section 751(a).

<sup>25</sup> Section 7701(a).

<sup>26</sup> Section 7701(c)-(d). Although what is included in qualifying income is more expansive than what constitutes qualifying income for RIC purposes, there are many similarities.

<sup>27</sup> Section 512(b)(1) and (5).

Meanwhile, a non-U.S. investor generally should not be concerned with ECI when investing in a RIC because, as a corporation, the RIC's activities are not attributable to its investors. As described above, however, a RIC's income does not pass through to investors in the same manner as it does for investors in a partnership. Unless otherwise classified, distributions from a RIC are generally treated as dividends and subject to U.S. withholding taxes.<sup>28</sup> For non-U.S. investors, dividends that are classified by the RIC as interest dividends or short-term capital gain dividends can escape U.S. withholding taxes, conforming this treatment to what a non-U.S. person would experience if it invested directly in the securities that produce that income.<sup>29</sup> In addition, since capital gain dividends are treated as long-term capital gain,<sup>30</sup> capital gain dividends are generally not subject to U.S. withholding.<sup>31</sup> It should be noted, however, that the 1980 Foreign Investment in Real Property Tax Act can still apply to distributions from a RIC and to the proceeds from the disposition of RIC shares.<sup>32</sup> The application of the FIRPTA rules is complicated and go beyond the scope of this article.

## V. Conversion

What is the actual process for income tax purposes of converting a private fund to a registered/public fund? Assuming the parties involved do not want the conversion to be a taxable transaction, because a RIC is a domestic corporation,<sup>33</sup> section 351 will control the conversion.

### A. Section 351

The path from a private fund to a registered fund usually takes the form of a newly formed entity that is treated for federal income tax purposes as a domestic corporation electing to be classified as a RIC. As described below, the investments of the private fund are then

transferred to the RIC in exchange for shares of the RIC. Section 351 generally provides that no gain or loss is recognized if property is contributed to a corporation by one or more persons in exchange for stock of the corporation and immediately afterward that person or persons own at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the stock of the corporation.<sup>34</sup>

The means of transferring the investments can take different forms, and Rev. Rul. 84-111, 1984-2 C.B. 88, provides three methods for converting a partnership into a corporation (including a RIC) through which the conversion can qualify for tax-deferred treatment under section 351. The partnership can transfer all its assets to the RIC in exchange for the corporation's shares, and the corporation assumes the partnership's assets. The partnership then liquidates and distributes the shares to its partners.<sup>35</sup> The second method provides for the partnership distributing all its assets and liabilities to its partners in termination of the partnership. The partners then contribute the assets to the corporation in exchange for corporate shares, and the corporation assumes the liabilities. The final method has the partners transferring their partnership interests to the corporation in exchange for shares of the corporation. Each method can work for the conversion to a registered fund,<sup>36</sup> but whichever method is chosen should provide the RIC with a clearly defined tax basis in its assets. The test to qualify for section 351 treatment seems straightforward, but there are many ways in which the conversion can fail to qualify for tax-free treatment.

<sup>28</sup> Section 1441.

<sup>29</sup> Sections 871(k) and 881(e).

<sup>30</sup> Section 852(b)(3)(A).  
<sup>31</sup> Section 871(a)(2).

<sup>32</sup> Sections 897(h) and 1445(e)(6).

<sup>33</sup> Section 851(a)(1).  
<sup>34</sup> Note that since the RIC's basis in the property received under section 351 is the same as the transferor's basis in that property, the method selected can affect the RIC's tax basis in its assets. A difference in tax basis can result in cases in which the investor in the private fund has either purchased its interest from an existing partner or inherited the interest, and the private fund does not have a section 754 election in effect. In these situations, a RIC's tax basis can be based on either the private fund's tax basis in its assets or the investors' tax basis in their interests.

## 1. Investment company and diversification.

The nonrecognition treatment provided under section 351 does not apply if the transfer of property is made to an investment company.<sup>37</sup> The regulations expand on what constitutes a transfer to an investment company and provide that a transfer of property will be considered a transfer to an investment company if:

- the transfer results, directly or indirectly, in diversification of the transferors' interest; and
- the transferee is a RIC, REIT, or a corporation in which more than 80 percent of the value of its assets held for investments are readily marketable stocks or securities, or interests in RICs or REITs.<sup>38</sup>

Diversification occurs if two or more persons transfer nonidentical assets in the exchange and generally will not occur if there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation. Transfers of nonidentical assets that constitute an insignificant portion of the total value of the assets transferred are ignored.<sup>39</sup> Subsequent transfers can create diversification for earlier transfers if they are part of a plan to achieve diversification.<sup>40</sup>

A transfer, however, will not result in diversification if each transferor transfers a diversified portfolio of stocks and securities.<sup>41</sup> To qualify as a diversified portfolio, no more than 25 percent of the value of the assets transferred by the transferor can be invested in the stock or securities of any one issuer, and no more than 50 percent of the value of the assets transferred can be invested in the stock and securities of five or fewer issuers.<sup>42</sup>

In cases in which one private fund is converting to a registered fund and is the

transferor with no plan for other persons making contributions, there should not be any diversification issues since there is only one transferor. If, however, two or more private funds are trying to combine into a new registered fund, it should be determined whether each private fund is contributing a diversified portfolio. What if Private Fund 1 and Private Fund 2 are combining operations to form a registered fund, and Private Fund 1 contributes a diversified portfolio but Private Fund 2 does not? In this scenario, should both Private Fund 1 and Private Fund 2 be denied tax-free treatment under section 351(a) or should only Private Fund 2 be denied this treatment?

As noted by the Tax Section of the New York State Bar Association,<sup>43</sup> the answer is unclear, but the better approach seems to be that only the person contributing the nondiversified portfolio should be denied tax-free treatment under section 351(a). On its face, section 351(e) does not provide different treatment for different transferors, but the addition of the diversification requirement could be interpreted as providing for this treatment. If Private Fund 1 did not possess control of the registered fund after the contributions, would Private Fund 2 be treated as a transferor for purposes of determining whether Private Fund 1 qualifies for tax-free treatment under section 351(a) even though Private Fund 2 is disqualified? If you read the regulations as providing for a transferor-by-transferor treatment and that Private Fund 1 did not achieve diversification by its contribution, then arguably Private Fund 1 should be accorded tax-free treatment even when it does not control the registered fund.

## 2. Cash.

How does cash affect diversification? If, as part of the formation of the registered fund, there is a public offering of the registered fund's shares to the public, does a cash contribution affect

<sup>37</sup> Section 351(e)(1). See also Jasper L. Cummings, Jr., "Transfer of Property to an Investment Company," *Tax Notes*, Jan. 18, 2010, p. 383, for an explanation of the history behind section 351(e) and the underlying regulations.

<sup>38</sup> Reg. section 1.351-1(c)(1).

<sup>39</sup> Reg. section 1.351-1(c)(7), Example 2 indicates that 1 percent or less would be considered insignificant.

<sup>40</sup> Reg. section 1.351-1(c)(5).

<sup>41</sup> Reg. section 1.351-1(c)(6).

<sup>42</sup> *Id.* (referencing section 368(a)(2)(F)(ii) and including government securities in total assets for purposes of the denominator in the 25 percent and 50 percent tests). See LTR 9821023 (May 22, 1998).

<sup>43</sup> New York State Bar Association Tax Section, "Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F)," Report No. 1252 (Dec. 28, 2011).

diversification? The IRS, in private rulings, has taken the position that cash contributions will not cause the transferors who contribute diversified portfolios to be taxed on those contributions.<sup>44</sup>

### 3. Immediately after.

Section 351(a) requires that the transferors are in control of the registered fund immediately after the exchange. In cases in which the private fund converts into a registered fund and members of the private fund that receive shares of the registered fund intend to sell those shares, will the "immediately after" requirement be met? When invoking the step-transaction doctrine, generally, if the members are not under a binding commitment to sell their shares or there is not a specific prearranged plan, the "immediately after" requirement should be met.<sup>45</sup>

The concept of a binding agreement seems straightforward, and an example of a prearranged plan can be found in Rev. Rul. 70-140, 1970-1 C.B. 73. In the ruling, A wholly owned all the stock of X, a corporation, and assets of a business A operated through a sole proprietorship. A, as part of an agreement with Y, an unrelated corporation, contributed the assets of the sole proprietorship to X in exchange for more corporate stock, and then A transferred his X stock to Y in exchange for Y common voting stock. The IRS concluded that (1) the two steps were part of a prearranged integrated plan and could not be considered independent and (2) the ownership of the additional X stock was transitory. Because of the transitory nature of the ownership of the additional X stock, section 351 did not apply to the contribution of the sole proprietorship assets to X.

Even though the IRS's conclusion in Rev. Rul. 70-140 relies on a prearranged integrated plan, many practitioners believe that, absent a binding commitment, separate steps cannot be combined in a section 351 transaction. "Although far from consistent, certain case law and IRS pronouncements indicate that, as a general matter, the binding commitment test, and not the

end result or interdependence test, governs whether the step-transaction doctrine applies to Code Section 351 transactions."<sup>46</sup> It seems clear that if there is a binding commitment for transferors to sell the registered fund shares received in the conversion, those shares would not be taken into account for purposes of meeting the immediately after requirement for section 351. If there is only the intent to sell without any legal or statutory obligation to do so, many practitioners would discount that sale in determining whether the requirements of section 351 have been met.<sup>47</sup>

### 4. Section 357(c).

If the private fund uses leverage to enhance its return and intends to convert to a registered fund through section 351, it must take section 357(c) into account. Section 357(c) applies to section 351 transactions when a taxpayer transfers property to a corporation in exchange for stock and the corporation assumes liabilities attached to the transferred property. While section 351 generally allows these transfers to occur without immediate gain or loss recognition, section 357(c) introduces an important exception: If the total amount of liabilities assumed by the corporation exceeds the aggregate adjusted basis of the property transferred, the excess is treated as taxable gain to the transferor. For a private fund with a low tax basis in its assets and liabilities, it is possible that the conversion could generate taxable income.

## B. Section 731

Assuming that the transfer of the private fund's assets to the registered fund is tax-free in accordance with section 351, the next step is to ensure that the exchange of ownership interests in the private fund by the partners for the registered fund shares is also tax-free. As noted above, Rev. Rul. 84-111 provides for three different approaches for incorporating a partnership.

<sup>44</sup> See LTR 200931042 (section 721(b) not applicable to formations in which a transferor contributes cash, diversified portfolios, or both), LTR 9826035.

<sup>45</sup> See LTR 9821023. See also Boris I. Bittker and James Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 3.09[2] (Aug. 2025 update).

<sup>46</sup> Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts* para. 608.3.3.4 (2025); see also Robert Rizzi, "Testing Binding Commitments for Section 351," 41 *Corp. Tax'n* 3 (May/June 2014).

<sup>47</sup> See LTR 9740029 (contributions by partnership to RIC is a good section 351 transaction even though followed by continuous public offering of RIC shares, but RIC will not have any binding commitment to issue shares to any person, and no partners will be under a binding agreement to dispose of RIC shares received from partnership).

When Situation 1 of Rev. Rul. 84-111 is the method of conversion, the private fund liquidates and distributes the underlying registered fund shares.<sup>48</sup> That liquidation has the potential to be a taxable event to the private fund partners.

Section 731 provides that liquidating distributions by a partnership generally do not result in gain or loss to the partners unless a partner receives money exceeding that partner's tax basis in his or her partnership interest. Marketable securities are generally treated as money and valued at their fair market value as of the date of distribution.<sup>49</sup> Publicly traded closed-end RIC shares and shares of open-end RICs are treated as marketable securities for these purposes.<sup>50</sup> RIC shares will not be considered marketable securities if the partnership is considered an investment partnership and the partner is treated as an eligible partner.<sup>51</sup>

An investment partnership means any partnership that has never been engaged in a trade or business, and substantially all the assets (by value) have always consisted of a specific list of assets.<sup>52</sup> An eligible partner is a partner who, before the date of distribution, did not contribute any property to the partnership other than those on the specific list.<sup>53</sup> In cases in which the partnership holds an interest in a lower-tier partnership, the code provides that the partnership will be treated as engaged in any trade or business the lower-tier partnership is engaged in and will hold a proportionate share of the underlying assets of the lower-tier partnership, and a partner that contributes a partnership interest will be treated as

<sup>48</sup> In cases in which the private fund is widely held, the most practical form of conversion would be for the private fund to make the contributions and liquidate so that the partners are not obligated to sign or be part of any transfer documents.

<sup>49</sup> Section 731(c)(1).

<sup>50</sup> Section 731(c)(2)(B)(i)(II).

<sup>51</sup> Section 731(c)(3)(A)(iii).

<sup>52</sup> Section 731(c)(3)(C)(i) (the assets consist of (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, (6) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of section 731(c)(3)(C)(i) or in any commodity traded on or subject to the rules of a board of trade or commodity exchange, (7) other assets specified in regulations, and (8) any combination of the above).

<sup>53</sup> Section 731(c)(3)(C)(iii).

contributing a proportionate share of assets of the other partnership.<sup>54</sup> The regulations modify this rule to provide that the partnership will not be treated as engaged in the lower-tier partnership's trade or business or hold a proportionate amount of assets of the lower-tier partnership if the partnership does not actively participate in the management of the lower-tier partnership and the interest held by the partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.<sup>55</sup> If a partnership interest is contributed to a partnership and the look-through provisions do not apply because of the limitations imposed by the regulations, that contributed partnership interest is treated as an asset in the specific list of assets.<sup>56</sup>

Assuming that most private funds are going to convert by contributing assets and liquidating and distributing the RIC shares to its partners, it's important to confirm that the private fund qualifies as an investment partnership and the partners are eligible partners. If the assets are significantly appreciated, it's possible for a partner who is not an eligible partner in an investment partnership to recognize gain on their receipt of the RIC shares in liquidation of the private fund.

## VI. RIC Status

After the conversion, the registered fund must now satisfy the RIC rules.

### A. Formation

A RIC is any domestic corporation that at all times is registered under the 1940 act as a management company or unit investment trust, or has in effect an election under the act to be treated as a business development company.<sup>57</sup> The RIC must also file an election with its return for the first year to which the RIC rules are to apply. The corporation makes the election by computing

<sup>54</sup> Section 731(c)(3)(C)(iv).

<sup>55</sup> Reg. section 1.731-2(e)(4).

<sup>56</sup> Section 731(c)(3)(C)(iv).

<sup>57</sup> Section 851(a)(1). A RIC can also be a domestic corporation that is a common trust fund or similar fund excluded by section 3(c)(3) of the 1940 act from the definition of investment company and is not included in the definition of common trust fund by section 584(a). Section 851(a)(2).

taxable income as a RIC in its return for the first tax year for which the election applies.<sup>58</sup>

## B. Income Test

Continuing qualification under the RIC rules requires, among other things, that the registered fund derive at least 90 percent of its gross income for each tax year from (1) dividends, interest, payments on securities loans and gains from the sale or other disposition of stock, securities, foreign currencies, or other income (including but not limited to gains from options, futures, and forward contracts) derived from its business of investing in that stock, securities, or currencies and (2) net income from certain qualified publicly traded partnerships (together with (1), the qualifying income requirement).<sup>59</sup> For these purposes, securities is defined under section 2(a)(36) of the 1940 act. Even though an instrument may constitute a security, it is not always clear whether that instrument will generate income that will satisfy the qualifying income requirement, as is the case with commodity-linked notes.<sup>60</sup>

The code provides relief if the RIC does not meet the qualifying income requirement.<sup>61</sup> The RIC must file a schedule of each item of gross income that meets the qualifying income requirement for that tax year, and the failure to meet the qualifying income requirement must be because of reasonable cause and not willful neglect. The RIC then pays a tax equal to the excess of the nonqualifying income over one-ninth of the qualifying income for that tax year. In other words, the RIC pays a 100 percent tax on the amount of nonqualifying income that is in excess of the permissible nonqualifying income.

## C. Asset Test

The RIC rules impose an asset diversification test, which consists of two tests. A RIC has to diversify its holdings so that at the close of each quarter of the tax year: (1) at least 50 percent of the value of its assets is comprised of cash, cash items (including receivables), U.S. government securities, securities of other RICs, and other securities — with those other securities limited, regarding any one issuer, to an amount that does not exceed 5 percent of the value of the fund's total assets and that does not represent more than 10 percent of the outstanding voting securities of such issuer and (2) not more than 25 percent of the value of its assets is invested in the securities (other than U.S. government securities or securities of other RICs) of any one issuer or the securities (other than the securities of other RICs) of two or more issuers controlled by it and engaged in the same, similar, or related trades or businesses, or one or more qualified publicly traded partnerships (together with (1) the diversification requirement).<sup>62</sup>

The diversification requirement must be met by the end of the first quarter and the end of each following quarter. The RIC rules, however, provide that after the RIC's first quarter in which it meets the diversification requirement, it will not fail the diversification requirement merely because of market fluctuations in the values of its investments. Furthermore, the fund will not lose its RIC status unless the discrepancy exists immediately after the acquisition of any security or other property and the discrepancy is wholly or partly the result of that acquisition.<sup>63</sup> Note that the discrepancy has to be as a result of an acquisition. Therefore, a violation will not happen unless there is an acquisition.<sup>64</sup> Nevertheless, if at the close of a quarter the RIC does not meet the

<sup>58</sup> Section 851(b)(1); reg. section 1.851-2(a).

<sup>59</sup> Section 851(b)(2).

<sup>60</sup> See Rev. Rul. 2006-31, 2006-1 C.B. 1133, modifying and clarifying Rev. Rul. 2006-1, 2006-2 CB 261. See also LTR 201113015. For the IRS's ruling position on any issue relating to the treatment of a corporation as a RIC under section 851 and related provisions that require a determination whether a financial instrument or position is a security as defined in the 1940 act, see Rev. Proc. 2017-3, 2017-1 IRB 130, 140, section 4.04(44).

<sup>61</sup> Section 851(i).

<sup>62</sup> Section 851(b)(3).

<sup>63</sup> Section 851(d)(1).

<sup>64</sup> See reg. section 1.851-5(a), Example 5 (providing that a RIC does not lose its status in cases in which, after distributions to its shareholders, it had more than 25 percent of its assets invested in a single corporation) and Example 6 (providing that a RIC does not lose its status in cases in which it failed the diversification requirement solely due to market fluctuations). See also LTR 8707033 (concluding that in cases in which a RIC has more than 25 percent of its assets invested in a single issuer solely because of market fluctuations, the acquisition of other investments that satisfy the diversification test would not cause the RIC to fail the diversification test).

diversification requirement because of an acquisition, the RIC has 30 days from the end of the quarter to eliminate the discrepancy. Other relief provisions are available if the discrepancy is not cured within 30 days, but these provisions become more onerous.<sup>65</sup>

For private funds whose only investment restrictions were based on the fund's investment strategy, navigating the qualifying income requirement and the diversification requirement may prove challenging. Certain investments, such as digital currencies, commodities, and real estate, will not qualify as securities or generate income that meets the qualifying income requirement. Some RICs will take problematic investments and drop them into a corporate subsidiary. The stock of the subsidiary will meet the restrictions of the diversification requirement, and related dividends and gains will satisfy the qualifying income requirement. The RIC, however, needs to ensure that the 25 percent test described above is not violated. Many RICs use this strategy to invest in commodities.

Investments in partnerships can prove especially difficult. Income from a partnership is acceptable income for the qualifying income requirement to the extent the income would qualify if it were earned directly by the RIC.<sup>66</sup> For the diversification requirement, although there is no direct authority, most practitioners would say that the partnership should be looked through and the RIC be treated as owning its allocable share of the underlying assets.<sup>67</sup> If a private fund has a strategy of investing in private equity funds, obtaining information from those funds to determine whether the diversification requirement and qualifying income requirement are met could prove challenging. Most private equity funds are familiar with requests regarding whether an investment in the fund will generate UBTI or ECI, but requesting information to help a RIC determine whether it satisfies the RIC rules is not something they often experience.

## D. Distribution Requirement

As a RIC, a registered fund will generally not be subject to U.S. federal income tax on the portion of its income and capital gains that it distributes to its shareholders in any tax year for which it distributes. In compliance with the RIC rules, this is the sum of (1) at least 90 percent of its ICTI (which includes dividends, taxable interest, taxable original issue discount income, market discount income, income from securities lending, net short-term capital gain in excess of net long-term capital loss, certain net realized foreign currency exchange gains, and any other taxable income other than "net capital gain" as defined below and is reduced by deductible expenses all determined without regard to any deduction for dividends paid); and (2) 90 percent of its tax-exempt interest, if any, net of certain expenses allocable thereto (net tax-exempt interest).<sup>68</sup> The registered fund does not have to distribute its net capital gain (that is, the excess of its net long-term capital gain over its net short-term capital loss) but rather may retain for investment all or a portion of it.<sup>69</sup> If the registered fund retains any ICTI or net capital gain, it will be subject to tax at regular corporate rates on the amount retained.<sup>70</sup> If the registered fund retains any net capital gain, it may designate the retained amount as undistributed net capital gain in a notice to its shareholders. The shareholders will be (1) required to include in income for federal income tax purposes, as long-term capital gain, their shares of the undistributed amount; and (2) entitled to credit their proportionate shares of tax paid by the registered fund against their federal income tax liabilities, if any, and to claim refunds to the extent the credit exceeds such liabilities.<sup>71</sup> For federal income tax purposes, the tax basis of the shares owned by a shareholder of the registered fund will be increased by the amount of undistributed net capital gain included in the shareholder's gross income and decreased by the

<sup>65</sup> Section 851(d)(2).

<sup>66</sup> Section 851(b)(2) (flush language, which provides similar treatment for trusts but excludes income from "qualified publicly traded partnerships").

<sup>67</sup> See Susan A. Johnston and James R. Brown Jr., *Taxation of Regulated Investment Companies and Their Shareholders* para. 2.07[7][b][vi] (June 2025 update).

<sup>68</sup> Section 852(a)(1). A RIC is also required to distribute by the end of the first tax year all its earnings and profits from previous tax years in which it did not qualify as a RIC. Section 852(a)(2).

<sup>69</sup> Section 852(b)(3).

<sup>70</sup> Section 852(b)(1), (b)(3)(A).

<sup>71</sup> Section 852(b)(3).

federal income tax paid by the fund on that amount of capital gain.<sup>72</sup>

A distribution will be treated as paid on December 31 of the calendar year if it is declared by the RIC in October, November, or December of that year to shareholders of record on a date in that month and paid by it during January of the following year. These distributions will be taxable to shareholders (other than those not subject to federal income tax) in the calendar year in which the distributions are declared rather than the calendar year in which the distributions are received.<sup>73</sup>

#### E. Excise Tax

If, by December 31 of each calendar year, a RIC fails to distribute an amount equal to the sum of (1) at least 98 percent of its taxable ordinary income (excluding capital gains and losses) for that year, (2) at least 98.2 percent of the excess of its capital gains over its capital losses (as adjusted for certain ordinary losses) for the 12-month period ending on October 31 of that year), and (3) all taxable ordinary income and the excess of capital gains over capital losses for the previous year that were not distributed during that year and on which it did not pay federal income tax, the RIC will be subject to a nondeductible 4 percent excise tax (the excise tax) on the undistributed amounts.<sup>74</sup>

#### F. Section 337(d)

If, as part of the conversion process and section 351 transaction, the registered fund receives assets from a corporation, the RIC will be subject to tax on the net built-in gain in the converted property under section 1374 and the accompanying regulations, as modified, as if the RIC were an S corporation.<sup>75</sup> These rules generally subject an S corporation to a corporate-level tax on the built-in gain attributable to the asset if the

asset is disposed of during the recognition period.<sup>76</sup> The RIC may make a deemed sale election at the time of the contribution to avoid the section 1374 treatment.<sup>77</sup> It would seem that if the private fund is a partnership, issues under section 337(d) should be easy to avoid. What if, however, the fund operated parallel funds — one a partnership for U.S. taxable investors and the other an offshore fund treated as a corporation for U.S. federal income tax purposes in which ECI and UBTI sensitive persons invested? If the conversion results in the offshore fund contributing its assets to the registered fund, section 337(d) would be implicated.

#### G. RIC Shareholders

As noted in Section IV above, the shareholders of a RIC have different income and reporting consequences as compared to partners in a private fund. Items of income, gain, loss, deduction, and credit do not flow through to shareholders as they do in a partnership. Instead, a RIC avoids taxation on its income if it distributes those amounts to its shareholders — a quasi-flow-through concept. As described further below, certain distributions and items deemed to flow through to shareholders must meet certain requirements for the flow-through treatment to be respected.

##### 1. Dividends generally.

Generally, subject to special classifications made by the RIC, a distribution from the RIC's earnings and profits will be treated as ordinary dividends. A RIC's distribution can be treated as qualified dividend income and therefore eligible for the long-term capital gains tax rate to the extent that the RIC receives dividend income from taxable domestic corporations and certain qualified foreign corporations, provided that certain holding periods and other requirements are met. A corporate shareholder of a RIC may be eligible for the dividends received deduction regarding the RIC's distributions attributable to dividends received by the RIC from domestic corporations, which, if received directly by the corporate shareholder, would qualify for such a

<sup>72</sup>Section 852(b)(3)(D).

<sup>73</sup>Section 852(b)(7).

<sup>74</sup>Section 4982.

<sup>75</sup>Reg. section 1.337(d)-7(b)(1)(i).

<sup>76</sup>Reg. section 1.337(d)-7(b)(1)(iii) (referencing section 1374(d)(7) and a five-year recognition period).

<sup>77</sup>Reg. section 1.337(d)-7(c).

deduction. For eligible corporate shareholders, the dividends received deduction may be subject to certain reductions, and a distribution by the RIC attributable to dividends of a domestic corporation will be eligible for the deduction only if certain holding periods and other requirements are met.

*a. Capital gain dividends.*

Distributions designated by the RIC as capital gain dividends (distributions from the excess of net long-term capital gain over short-term capital losses) will be taxable to shareholders as long-term capital gain regardless of the length of time they have held their shares of the RIC. These dividends do not qualify as dividends for purposes of the dividends received deduction described above.

*b. Exempt-interest dividends.*

If at least 50 percent of the value of a RIC's assets at the close of each quarter consists of tax-exempt obligations, such as municipal bonds, the RIC may pay exempt-interest dividends. The RIC must designate the distribution as an exempt-interest dividend, and the shareholders can then treat that dividend as interest excludable from gross income under section 103(a).<sup>78</sup>

*c. Section 163(j) interest dividends.*

A RIC can designate distributions as section 163(j) interest dividends to the extent of the RIC's excess section 163(j) interest income, which is the RIC's business interest income for the year, reduced by the sum of: (1) the RIC's business interest expense for the year and (2) the RIC's other deductions for the year that are properly allocable to the RIC's business interest income.<sup>79</sup> Subject to certain limitations and holding period requirements, shareholders who receive section 163(j) interest dividends may treat them as interest income for purposes of their own section 163(j) limitation.<sup>80</sup>

*d. Section 199A dividends.*

A RIC may pay section 199A dividends to its shareholders if it receives qualified REIT

dividends during the tax year. The amount of section 199A dividends a RIC can report is limited to its qualified REIT dividends includable in its taxable income for the year, reduced by any deductions properly allocable to that income. Shareholders who receive section 199A dividends from a RIC and meet certain holding period requirements may treat those dividends as qualified REIT dividends for purposes of the section 199A deduction (that is, receive a 20 percent deduction to the extent of the section 199A dividend received).<sup>81</sup>

*e. Interest-related dividends and short-term capital gain dividends.*

A RIC may designate certain dividends as either interest-related dividends<sup>82</sup> or short-term capital gain dividends.<sup>83</sup> To the extent these dividends qualify, they will not be subject to the 30 percent tax imposed under section 871 and 881 or the applicable withholding tax.

*f. Undistributed capital gains.*

A RIC does not need to distribute its net capital gain; instead, it can retain it and pay a corporate-level tax on the undistributed amount.<sup>84</sup> For the shareholders, they must include in computing their long-term capital gains the amount the RIC designates on Form 2439 as undistributed long-term capital gains. The shareholders will be treated as paying the tax imposed on the RIC on the undistributed net capital gain, and the shareholder's adjusted basis in their RIC shares will be increased by the difference between the amount included in their income and the tax deemed paid by the shareholder regarding their RIC shares.<sup>85</sup>

## 2. Deductions.

RIC shareholders do not generally take into account RIC level deductions, but there are exceptions.

<sup>78</sup> Section 852(b)(5).

<sup>79</sup> Reg. section 1.163(j)-1(b)(35).

<sup>80</sup> Reg. section 1.163(j)-1(b)(22)(iii)(F)(1).

<sup>81</sup> Reg. section 1.199A-3(d).

<sup>82</sup> Sections 871(k)(1) and 881(e)(1).

<sup>83</sup> Section 871(k)(2) and 881(e)(2).

<sup>84</sup> Section 852(b)(3)(A). The amount is reported by the RIC on Form 2438, "Undistributed Capital Gains Tax Return."

<sup>85</sup> Section 852(b)(3)(D).

### *a. Foreign tax credits.*

If more than 50 percent of a RIC's total assets at the close of any tax year consist of stock or securities of foreign corporations and meet the distribution requirements described above, the RIC may file an election with the IRS under which the RIC's shareholders would be required to (1) include in gross income (in addition to taxable dividends actually received) their pro rata shares of foreign income taxes paid by the RIC even though the shareholders did not actually receive them; and (2) treat those respective pro rata portions as foreign income taxes paid by them.

### *b. Dividends received deduction.*

If a RIC receives dividends from a corporation, it is not allowed a dividends received deduction in calculating its ICTI.<sup>86</sup> A corporate shareholder, however, may be eligible for the dividends received deduction regarding the RIC's distributions attributable to dividends the RIC received from domestic corporations, which, if received directly by the corporate shareholder, would qualify for such a deduction. For eligible corporate shareholders, the dividends received deduction may be subject to certain reductions, and a distribution by the RIC attributable to dividends of a domestic corporation will be eligible for the deduction only if certain holding period and other requirements are met. If the RIC's shares are loaned in accordance with a securities lending agreement, dividends paid while the shares are held by the borrower may not be qualified dividend income and may not qualify for the dividends received deduction.

### *c. Itemized deductions.*

Individuals are limited in their ability to deduct miscellaneous itemized deductions, which are itemized deductions other than those specifically excluded by statute, such as interest, taxes, casualty or theft losses, charitable contributions, medical expenses, etc.<sup>87</sup> Generally, miscellaneous itemized deductions are only

allowed to the extent that the aggregate of those deductions exceeds 2 percent of the taxpayer's adjusted gross income.<sup>88</sup> From 2018 through 2025, the ability to deduct miscellaneous itemized deductions was suspended, and in 2025 the prohibition on deduction was made permanent.<sup>89</sup> For entities that are considered passthrough entities, the code prevents the equity holder's ability to indirectly deduct these expenses through the entity.<sup>90</sup>

Shareholders of publicly traded RICs are not affected by these rules. A RIC will be treated as publicly offered if its shares are (1) continuously offered to the public under a public offering as defined by section 4 of the Securities Act of 1933 (as amended), (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. Nonpublicly offered RICs are among the passthrough entities subject to these rules.<sup>91</sup> For shareholders of nonpublicly traded RICs that are (1) individuals (other than a nonresident alien whose income regarding his or her interest in the passthrough entity is not effectively connected with the conduct of a trade or business within the United States), (2) persons, including trusts or estates, that compute their taxable income in the same manner as in the case of an individual, or (3) passthrough entities (as described above) if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (A) a passthrough entity or (B) a person described in (1) or (2) above.<sup>92</sup> These affected shareholders will be treated as if they received a dividend equal to any expenses that, if paid or incurred by an individual directly would be subject to the 2 percent floor, other than certain organizational and administrative expenses.<sup>93</sup>

<sup>86</sup> Section 67(a).

<sup>87</sup> Section 67(h).

<sup>88</sup> Section 67(c). A passthrough entity includes a grantor trust, partnership, S corporation, common trust fund, another nonpublicly offered RIC, a real estate mortgage investment conduit, or any other person that is not subject to tax or allowed a dividends paid deduction, but the character of whose income passes through to its shareholders. It does not include a qualified pension plan, an individual retirement account, or insurance companies holding assets in separate accounts to fund variable contracts. Reg. section 1.67-2T(g)(1).

<sup>89</sup> Reg. section 1.67-2T(g)(3).

<sup>90</sup> Reg. section 1.67-2T(h)(1).

<sup>91</sup> Reg. section 1.67-2T(j) and (i).

<sup>86</sup> Section 852(b)(2)(C).

<sup>87</sup> Section 67(b).

## VII. Conclusion

As private funds consider restructuring to capitalize on the retail market as registered funds, the path to converting into a registered fund and being taxed as a RIC is fraught with challenges. The private fund must determine its form of conversion and navigate the requirements of a section 351 transaction to determine whether any gain is recognized on the transaction. After the conversion, the registered fund must comply with the RIC rules. Investment managers should familiarize themselves with these rules and understand the limitations that are imposed under the diversification requirement and the qualifying income requirement. A registered investment fund taxed as a RIC offers its investors many tax advantages over an investment in a private fund taxed as a partnership and is a worthwhile structure to pursue. ■

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