

# Business development companies: understanding tax-related opportunities and challenges

Venture capital and private equity funds are well-known and important sources of investment money for startup firms and small businesses that face difficulty raising capital through conventional debt or equity offerings yet offer long-term growth potential.

Most venture capital comes from wealthy individuals and families, investment banks and other financial institutions that pool such investments or partnerships. While these investors can provide significant capital, they also represent a relatively small slice of the total investing public. Thus, venture capital's defining characteristic also can be a significant weakness.

As an alternative, in the 1980s, the Federal government created a venture-like investment vehicle known as a "business development company" (BDC). Congress designed BDCs to help emerging U.S. businesses raise funds to fuel job growth. BDCs provide capital and supply financing to companies through a wide variety of mechanisms, including equity, debt and hybrid financial instruments.<sup>1</sup>



“Publicly traded BDCs offer investors and the general public a highly liquid opportunity to access the emerging growth market while providing BDCs access to large volumes of capital that lie outside the reach of venture capital.”

<sup>1</sup> <http://bluevaultpartners.com/industry-intel/business-development-company-bdc-history/>



But one other key characteristic distinguishes BDCs: while private equity and venture capital funds are always privately held, BDCs can be either non-listed (privately held) or publicly traded on the major stock exchanges in the same way as stocks and exchange-traded funds (ETFs). Publicly traded BDCs offer investors and the general public a highly liquid opportunity to access the emerging growth market while providing BDCs access to large volumes of capital that lie outside the reach of venture capital.

Driven by a potentially unlimited investor pool, about 50 BDCs are currently traded on U.S. equities markets<sup>2</sup> — more than triple the number of about 10 years ago. According to a late-2015 report, total assets ballooned to over \$60 billion in 2014 from about \$12.5 billion in 2005.<sup>3</sup>

Although publicly traded BDCs generally attract the most attention, beginning in 2009 the first non-listed BDC was launched. Starting in 2011 and over the next several years, about 25 additional non-listed BDCs were formed. Non-listed BDCs are only available through broker-dealers and financial advisers, and only then during extended offering periods. They are not nearly as liquid as their publicly traded counterparts although, upon formation, they plan for a liquidity event, which is typically anticipated to occur within five to seven years.<sup>4</sup>

### Regulatory considerations

From a regulatory perspective, the Securities and Exchange Commission (SEC) imposes a number of requirements on BDCs, including the annual filing of Form 10-Ks and quarterly filings of Form 10-Qs, both of which are quite extensive.

Additionally, the treatment of BDCs under federal tax rules is typically different than other corporations, according to Bob Dunne, Grant Thornton Tax partner specializing in investment taxation and the taxation of registered investment companies (RICs). “In order to flow through their income to investors and avoid incurring entity-level tax, BDCs, taxed as corporations, must meet a number of qualification requirements, including adhering to certain investment restrictions. Given the SEC filings requirements and the investment restrictions, the relative scarcity of BDCs isn’t totally surprising.”

The requirements that a BDC must meet to qualify and enjoy the benefits of RIC taxation status include the following:

- **Good income.** Generally, at least 90 percent of a BDC’s annual gross income must be derived from dividends, interest, gains from the sale or exchange of securities, income from security lending, income from qualified publicly traded partnerships, and other “qualifying” income associated with the business of investing in securities.

<sup>2</sup> Per SEC data (<https://www.sec.gov/open/datasets-bdc.html>), from 2012 through September 2017, 135 companies declared their intent to be regulated as BDCs by filing a Form N-6F, or have elected to be regulated as BDCs by filing a form a Form N-54A. However, the SEC report includes Form N-6F filers and BDCs that have not yet begun selling shares to the public, as well as those that have ceased operations but have not yet withdrawn their registration statements or elections by filing a Form N-54C. Actual number of actively traded BDCs estimated based on Grant Thornton data gathering.

<sup>3</sup> Statistics report by Raymond James Financial Services Investment Bank at the 13th Annual BDC Roundtable, September 2015, sponsored by Eversheds Sutherland (US) LLP.

<sup>4</sup> Most plan to eventually list their shares and become publicly traded BDCs, although there are additional options which include: 1) a reorganization or acquisition transaction with a publicly traded company, 2) assets sold in a one-time transaction, or 3) assets sold in small lots over time. Of all the non-listed BDCs formed to date, only two have completed their liquidity events (both becoming publicly traded entities), and a third is working through the process

- **Asset diversification.** An RIC must pass asset diversification requirements on a quarterly basis, measured by both “50 percent” and “25 percent” tests. To pass the 50 percent test, a BDC must have at least half of its total gross assets represented by “good” assets. Generally, “good” assets are cash, receivables, government securities, investments in other RICs, as well as investments in securities that represent 5 percent or less of the value of the total gross assets of the BDC and 10 percent or less voting control of any single issuer. In addition, a BDC cannot have more than 25 percent of the value of its total gross assets invested in one issuer (other than RICs and government securities), any two or more issuers controlled by the BDC who are engaged in the same or similar businesses or one or more “qualified publicly traded partnerships.”<sup>5</sup>
- **Income distribution.** Finally, to qualify as an RIC, a BDC must distribute 90 percent or more of its ordinary income and net short-term capital gains annually to its shareholders.

According to Heidi Ryan Patton, Grant Thornton Tax senior manager, the hurdles that a BDC must overcome to meet RIC requirements can seem daunting. However, she notes, “We know from experience that, with appropriate foresight and planning, that these requirements can be managed.”

### RIC vs. partnerships tax treatment

For private equity firms who are accustomed to partnership taxation, the rules that govern RIC taxation, which generally apply to BDCs, may be unfamiliar. Accordingly, a new BDC should consider planning in the early stages of formation with their tax advisor in order to minimize the possibility of RIC disqualification that could lead to corporate level tax. Also, a former C corporation that converts to RIC status has special tax considerations.

For investors, there are advantages and disadvantages to each approach.

Some advantages to investors in RICs include:

- **Income reporting to investors.** BDCs report income to investors as dividends on a 1099 form rather than the K-1 used by partnerships. According to Sang Lee, a Grant Thornton Tax manager, investors typically prefer a 1099. “Income reported on a Form 1099 generally provides an easier filing basis and is typically reported in a more timely manner,” he said.
- **Deductibility of expenses.** RICs are more likely to get unlimited deductions (i.e. no 2 percent of adjusted gross income limitation) under IRC section 67 and the related regulations.
- **Unrelated business income tax (UBIT).** BDCs are UBIT “blockers,” giving them a potentially significant advantage in attracting investments from pension plans, private foundations and other tax-exempt organizations.
- **Income timing.** RICs may distribute income up to one year after the fiscal year-end in which it is earned, thereby deferring the taxation of that income for its shareholders. However, this is not the outsized benefit that it may seem as RICs are also subject to an excise tax that encourages more rapid income distributions. In fact, the excise tax can substantially offset the benefits of income timing (see below).
- **State taxation.** Taxable shareholders of an RIC typically only pay tax to their resident state on income received from an RIC. However, a private equity fund that has a nexus in multiple states can subject their investors to multi-state taxation. Although RICs could have exposure at the entity level for state taxes, depending on their investments, most states provide exceptions and limitations with respect to RIC taxation.

<sup>5</sup> To learn more about IRS regulations with respect to 25% controlled group asset diversification, reference this article: <https://www.grantthornton.com/library/whitepapers/financial-services/2017/AM/RIC-controlled-group-regulations.aspx>

Finally, while it's not necessarily an "advantage" per se, RICs receive flexibility under tax law for post-October capital losses/late-year losses. Unlike partnerships, RICs may elect to defer certain post-October capital losses and certain post-October ordinary losses (such as foreign currency losses and PFIC losses). In addition, non-calendar year-end RICs may elect to defer certain post-December ordinary losses, treating them as occurring on the first day of the following fiscal tax year. The deferral election allows for income tax/excise tax (see below regarding excise tax) coordination as well as the mitigation of possible 1099 designation issues. Additionally, it may preserve the utilization of such losses to offset future income.

Looking from the opposite perspective, there are areas where partnership taxation provides a favorable result for investors. For example:

- **Portfolio investment limitations.** As noted above, the RIC qualification requirements provide a significant restriction on investments. It is a trap for the unwary. Partnerships, unless they are publicly traded, have no such limitations.
- **Net short-term capital gains.** While partnerships pass through short-term capital gains, these are treated as ordinary income for RICs. Thus, partners may use capital gains from the partnership to absorb short-term capital losses from other sources.
- **Capital loss carryover.** Partners get capital losses from the partnership that could result in an immediate tax benefit, whereas capital losses are carried at the entity level for RICs.
- **Excise tax (IRC section 4982).** As mentioned above, excise tax rules encourage RICs to make distributions on a calendar year basis without regard to the RIC's fiscal year end. Although there is no impact to the RIC's qualification status if undistributed income is not distributed by calendar year-end, a 4 percent tax is levied on any undistributed income. In addition, the excise tax regime requires additional tracking and administrative considerations.

- **Income allocations.** RICs allocate distributions to shareholders under the C corporation tax rules, whereas partnerships generally allocate income under IRC section 704. The allocations under the partnership tax rules allow for more flexibility, although there are a number of technical considerations that can apply to partnerships that do not apply to RICs.
- **ASC 740.** As RICs have more potential for an entity level tax, FIN 48/ASC 740 are a more significant consideration for RICs. However, the new partnership audit regime could close the gap here in future years pending guidance by regulatory authorities.
- **Ownership changes.** In general, corporate ownership change rules under IRC sections 381 through 384 apply to RICs but not to partnerships. For RICs, the rules can limit certain realized and built-in losses and may significantly limit the ability to utilize a carry-forward loss from a prior year to a future year. On the other hand, while private venture partnerships may undergo technical terminations if there is a 50 percent or more change in ownership, given the liquidity limitations, ownership change rules typically don't apply.



### Careful planning offers potential rewards and avoids traps

Although there are numerous regulatory issues to consider in forming and operating as a publicly traded BDC, the potential significant advantages make at least exploring the BDC structure worthwhile. “The opportunity to tap a broader base of new investors and a much larger pool of capital is compelling,” Dunne explained. “One key is to establish and maintain a structure and investment strategy that allows the BDC to be taxed favorably as an RIC.”

The tax challenges may often be navigated with proper upfront planning. For example, BDCs often use “blocker corporations” to hold assets that do not generate good income (e.g. certain partnership investments). Because distributions of earnings from blocker corporations to BDCs come in the form of dividends, they are considered “good income”.

However, when using blocker corporations, BDCs must also keep sight of the asset diversification requirements. For a BDC, an investment in a blocker corporation, where the BDC holds more than 10 percent voting control, would be considered a bad asset. In addition, federal and state tax ramifications of the blocker corporation, a C corporation, must be considered.

The reality is that careful tax planning on a timely basis is often overlooked as a key component to forming a successful BDC. “Jumping into a BDC structure without consideration of the potential tax implications, can result in the BDC being inadvertently classified as a C corporation resulting in significant federal and state tax consequences,” Dunne said. “But with the right upfront planning and ongoing monitoring, a BDC can adopt a structure and investment strategy that preserves the tax benefits of RIC taxation for the entity and its investors.”

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