



Evaluating the tax impact of COVID-19 on RICs and their shareholders

Five key steps to enhance your tax position

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As COVID-19 continues to unfold, its wide-ranging impact on the financial and capital markets, the liquidity challenges it's created, and the overall atmosphere of economic uncertainty becomes more evident. In particular, its potential tax impact on regulated investment companies (RICs) and their shareholders is beginning to come into clearer focus.

This article is intended to provide a working checklist for the top five key tax issues that have emerged to date for RICs of all types—mutual funds, exchange traded funds (ETFs), closed-end funds, fund of funds, and business development companies (BDCs).

1 Stay informed about regulatory developments
Regulatory and legislative guidance is being issued at a rapid pace. Industry associations also are requesting new relief¹ and expansions of existing relief. So it is critical that you stay informed about these fast-moving developments. Guidance issued to date includes:

Income tax payment/filing relief: Federal (and a number of states)² return filing and income tax payments deadlines generally have been postponed from April 15 to July 15.³

CARES Act: Several pieces of legislation designed to address COVID-19 have been enacted, including the CARES Act.⁴ While the CARES Act doesn't include specific relief for RICs, it's possible that future legislation may do so. For example, RICs are currently unable to carry forward net operating losses (NOLs) and Congress could change this.

Key steps to help bolster tax positions for RICs and their shareholders

1. RICs and their investors should stay informed during this fast-moving regulatory and legislative environment.
2. Actively monitor asset and income qualification requirements.
3. Consider deploying cash conservation and alternative distribution strategies to increase cash reserves/prepare for investment opportunities.
4. Assess the impact of market conditions on portfolio holdings and transactions.
5. Manage liquidity issues for money market funds.

¹ For example, on March 23, 2020, the Investment Company Institute (ICI) submitted a letter to the Treasury Department and Internal Revenue Service (IRS) requesting an expansion of the taxpayer filing and payment relief provided in Notice 2020-18, 2020-15 IRB 592, for RICs. As discussed below, the IRS provided further relief for taxpayers, including RICs, in Notice 2020-23, 2020-18 IRB.

² View the [KPMG state tax obligation tracker](#) for up-to-date deadlines.

³ Notice 2020-23 generally provides that any filing or payment obligations listed in the Notice, including Form 1120-RIC, that are due on or after April 1 and before July 15 (including original and extended due dates) are postponed until July 15. The Notice also postpones the due dates for "time-sensitive acts" (e.g., refund claims) until July 15.

⁴ The Coronavirus Aid, Relief, and Economic Security (CARES) Act (H.R. 748, Public Law 116-136).

In addition, provisions of the CARES Act may provide “carryback” relief for NOLs to corporate entities or blockers in RIC structures.⁵ The CARES Act also lessens some of the detrimental effects of section 163(j), which generally disallows interest deductions to the extent net business interest expense exceeds 30 percent of a corporation’s adjusted taxable income (ATI). Specifically, the CARES Act increases the ATI limitation for corporations from 30 percent to 50 percent for 2019 and 2020 and allows taxpayers to elect to use 2019 ATI when calculating their 2020 limitation.⁶



Actively monitor asset and income qualification requirements

COVID-19 has impacted financial markets and asset valuations. It is important to actively monitor asset and income levels to ensure compliance with RIC qualification requirements. Here are some items to consider:

Qualifying RIC income: For income qualification purposes, at least 90 percent of a RIC’s gross income must come from certain qualified sources, or so-called “good income.”⁷ So to qualify as a RIC, no more than 10 percent of its gross income can be derived from “bad income.”

Because COVID-19 has created financial stress, previously permissible amounts of “bad income” might unexpectedly exceed the 10 percent threshold because of a relative decline in the amount of “good income.” For example, borrower defaults might reduce a RIC’s interest income (i.e., “good income”) and result in the acquisition of foreclosure property that produces “bad income.” RICs should actively monitor their qualifying RIC income and model potential portfolio scenarios to stay ahead of this issue.⁸

Asset diversification test: A RIC generally must comply with two asset diversification tests at the close of each quarter—a 50 percent test⁹ and a 25 percent test.¹⁰ (Note that there are some limited provisions allowing RICs to “cure” violations of the diversification tests.)

In light of COVID-19’s impact on the financial markets, RICs need to be especially mindful of actively monitoring their ability to comply with both the 50 percent and 25 percent asset diversification tests. (Note that the U.S. Securities and Exchange Commission [SEC] has announced that it is providing temporary and conditional relief for BDCs, allowing them to make additional investments in small- and medium-sized businesses, including those with operations affected by COVID-19.¹¹)

Areas of special concern for RICs include unexpected concentration in assets that may not be eligible for relief under the “market appreciation” exception due to ongoing purchases and reinvestments in securities.¹² Also, note that employing some available cures may have unintended negative consequences as a result of required rebalancing of the RIC’s portfolio and, in some cases, the payment of a \$50,000 penalty tax.¹³

What’s more, if a RIC fails to qualify for RIC treatment (whether intentionally or unintentionally) it could be subject to a corporate level tax on built-in gains when it subsequently requalifies as a RIC.¹⁴ A RIC may avoid this corporate level tax by re-electing RIC status immediately following the non-qualifying year.¹⁵

⁵ For example, Section 2303 of the CARES Act grants taxpayers a five-year carryback period for NOLs arising in tax years beginning after December 31, 2017 and before January 1, 2021 (i.e., calendar years 2018, 2019, and 2020). As a result of the extended carryback provision, a corporation can carryback NOLs to offset pre-2018 ordinary income and capital gains that were taxed at rates up to 35 percent, thereby generating a current refund and a favorable rate differential.

⁶ Section 2306 of the CARES Act and IRC 163(j).

⁷ Good income for this purpose includes dividends, interest, payments with respect to securities loans, gains from the sale or other disposition of stock or securities, foreign currencies or other income derived by a RIC from its business of investing in such stock, securities and foreign currencies, and net income derived from an interest in a qualified publicly traded partnership. See IRC 851(b).

⁸ A RIC is permitted to cure a failure of the qualifying income requirement where such failure is due to “reasonable cause.” Where the cure applies, the RIC must file a schedule of each item of its gross income for the taxable year and pay a tax equal to the amount of its excess nonqualifying income (i.e., the RIC’s nonqualifying income in excess of 1/9th of its qualifying income). This tax is deductible by the RIC in computing its investment company taxable income. See IRC 851(i) and IRC 852(b)(2)(G).

⁹ Under the 50 percent test, at least 50 percent of a RIC’s total assets must be in cash and cash items, government securities, securities of other RICs, and other limited investments not exceeding 5 percent of the RIC’s total assets or 10 percent of the voting securities of any one issuer. See IRC 851(b)(3)(A).

¹⁰ Under the 25 percent test, no more than 25 percent of a RIC’s total assets may be invested in (1) the securities (other than government securities or the securities of other RICs) of any one issuer, (2) the securities (other than securities of other RICs) of two or more issuers which the RIC controls and which are determined to be engaged in the same or similar or related trades or businesses, or (3) the securities of one or more qualified publicly traded partnerships. See IRC 851(b)(3)(B).

¹¹ SEC Order Granting Exemptions From Specified Provisions of the Investment Company Act and Certain Rules Thereunder (Release No. 33837, April 8, 2020).

¹² IRC 851(d)(1).

¹³ IRC 851(d)(2).

¹⁴ IRC 337(d); Treas. Reg. 1.337(d)-7.

¹⁵ Treas. Reg. 1.337(d)-7(d)(2).

3

Consider cash conservation and alternative distribution strategies

A RIC may have a reduction in cash receipts limiting its investment opportunities and putting pressure on its dividend distribution policies. For example, these situations may arise from:

- A reduction in interest income due to borrower defaults and any potential receipt of “negative interest.”
- Changes in dividend distribution policies by issuers of portfolio securities and other portfolio investments, including fund of fund structures, implementing various cash conservation strategies.
- For BDCs, increased amounts of noncash accruals where borrowers choose to pay interest “in-kind,” rather than in cash.

In light of current and anticipated strains on cash receipts, RICs may consider the deploying various cash conservation and alternative distribution strategies. These strategies could include:

- **Elective stock dividends:** Publicly offered RICs (or real estate investment trusts [REITs]) may use elective stock dividends under certain conditions, including a requirement that at least 20 percent of the aggregate declared distribution must be in cash (at the election of the shareholder).¹⁶ If the conditions are satisfied, the IRS will treat the distribution of stock and cash as dividends for purposes of the RIC distribution test¹⁷ and the dividends paid deduction.

One consequence of this election is that a RIC seeking to maintain the same dividend rate per share will likely have greater future dividend distributions because there will be more shares outstanding. In addition, RIC shareholders may need cash from elsewhere to cover the tax liability associated with an elective stock dividend. And, where an upper-tier RIC is a shareholder in another RIC or REIT opting to make an elective stock dividend, the RIC needs to consider the impact on its own cash flow and distribution requirements.

In prior periods of economic stress, the IRS has permitted publicly offered RICs and REITs to make elective stock dividends with a minimum cash component of 10 percent of the aggregate declared distribution.¹⁸ Following industry requests, the IRS has issued similar, temporary relief in response to the COVID-19 pandemic.¹⁹

- **Intentional payment of excise tax:** A RIC generally pays a 4 percent excise tax annually to the extent it fails to distribute at least 98 percent of its ordinary income and 98.2 percent of its capital gain net income (generally measured for the one-year period ending on October 31).²⁰ However, in the current liquidity and investment environment, a RIC may conclude that the benefits of retaining cash outweigh the cost of paying the excise tax.
- **Use of consent dividends:** By using a consent dividend, a RIC may claim a dividends paid deduction without actually distributing cash to shareholders.²¹ However, the ability to use a consent dividend is limited as a practical matter because the RIC needs to obtain consent from all shareholders. Consent dividends have been used by RICs supporting separately managed accounts of an insurance company or RICs wholly owned by other RICs in a fund of funds structure. Keep in mind that consent dividends generate phantom income for RIC shareholders, which may not be a welcome result for them.²²
- **Use of equalization (where available):** A RIC may claim a dividends paid deduction in respect of shareholder redemptions treated as sales or exchanges to the extent they reduce the RIC’s accumulated earnings and profits.²³ The use of equalization reduces the amount of earnings and profits remaining to be distributed to the RIC’s nonredeeming shareholders.
- **In-kind redemptions:** In-kind redemptions are routinely used by ETFs holding securities and other RICs may use them as well.²⁴ With an in-kind redemption, a RIC doesn’t need to sell securities to generate cash, and any gain on an appreciated security isn’t recognized by the RIC.

¹⁶ See “safe harbor” relief provided in Revenue Procedure 2017-45, 2017-35 IRB 216.

¹⁷ IRC 852(a)(1) and 561.

¹⁸ See Rev. Proc. 2008-68, 2008-2 CB 1373 (applicable to REITs for dividends declared with a taxable year ending on or before December 31, 2009); Rev. Proc. 2009-15, 2009-4 IRB 356 (extending Rev. Proc. 2008-68 to RICs) and Rev. Proc. 2010-12, 2010-3 IRB 302 (extending effective date of Rev. Proc. 2009-15 to December 31, 2011).

¹⁹ See Rev. Proc. 2020-19, 2020-22 IRB (applicable to distributions declared by a publicly offered RIC or REIT on or after April 1, 2020 and on or before December 31, 2020); National Association of Real Estate Investment Trust (NAREIT) letter to Treasury Department seeking a temporary reversion for 2020 and 2021 to the 10 percent minimum cash component for elective stock dividends (March 18, 2020) and Dechert LLP letter to Treasury Department asking for similar guidance that would apply to all RICs (whether publicly offered or not) for all distributions paid on or before the date which is two years from the termination of the National Emergency as declared by President Trump on March 13, 2020.

²⁰ IRC 4982.

²¹ RA consent dividend is treated as distributed by the RIC on the last day of the RIC’s taxable year and reduces the RIC’s earnings and profits in the same manner as an actual distribution of earnings and profits. See IRC 561(a)(2); 565, Treas. Reg. 1.565-1; Treas. Reg. 1.565-3(a).

²² Shareholders increase the basis in their RIC shares by the amount of the consent dividend deemed received and contributed to the RIC.

²³ IRC 562(b) and 302(b).

²⁴ IRC 852(b)(6). A RIC using in-kind redemptions is required to comply with nontax requirements, including those provided by its governing documents.

At the same time, the RIC may not recognize losses on an in-kind redemption.²⁵ So the RIC should carefully assess which securities in its portfolio to use for this purpose. Also, an in-kind redemption is treated as a taxable exchange for a redeeming RIC shareholder.

- **Disaster loss election:** A taxpayer may elect to deduct qualified 2020 “disaster losses” in 2019. In light of the National Emergency declared by President Trump on March 13, 2020, the United States is considered a qualified disaster area. Among other requirements, deductible disaster losses must be attributable to the disaster (i.e., some direct causation) and must have occurred within the disaster area.²⁶

Where a RIC paid income tax or excise tax in 2019, it could consider making a disaster loss election. Potentially deductible disaster losses for a RIC could include losses on securities (1) disposed of at a loss, (2) that become worthless, or (3) are written down under a mark-to-market method.²⁷
- **Undistributed capital gain dividends:** A RIC may elect to include some or all of its undistributed net capital gains in the income of its shareholders.²⁸ RIC shareholders are given a credit for the amount of tax paid by the RIC with respect to undistributed net capital gains. Their basis in their RIC shares is increased by the net amount of includible gains retained by the RIC.²⁹ (Note that not all states follow the federal treatment of undistributed capital gain dividends.)
- **Rights offering to raise cash:** BDCs and closed-end funds looking to increase liquidity may want to consider a rights offering to their shareholders allowing them to purchase shares at a discounted price. However, funds should consider that the rights offering may dilute the value of their shares and evaluate the tax implications for shareholders.³⁰
- **Monitor that proper withholding tax rates are being assessed:** Due to the impact of COVID-19, RICs and their global custodians are struggling to meet various “wet ink” signature, notary, paper filing, and other requirements associated with tax reclaim and treaty relief, both in the United States and globally. While a number of jurisdictions

are issuing relief in this regard, the situation remains fluid.³¹

- **Share repurchase programs:** BDCs and closed-end funds may want to consider capitalizing on recent share price declines by repurchasing their shares at significantly depreciated prices; this may also result in a deduction for dividends paid.³² So in addition to providing an economic benefit, share repurchase programs may help a RIC manage taxable income if it is anticipating a decrease in ordinary distributions.

4

Manage liquidity issues for money market funds

Where a money market fund is permitted or required to impose liquidity fees or “redemption gates,”³³ it should assess the potential tax consequences to the fund and its shareholders. Over the years, industry participants have requested guidance from the IRS treating liquidity fees received by a stable net asset value (NAV) money market fund as resulting in no gain or loss to the fund and as a reduction in gross proceeds to a redeeming shareholder. Guidance also has been requested from the IRS to confirm that the fund will be deemed to have sufficient earnings and profits to support any distribution of liquidity fees required to prevent it from “breaking the buck” on the upside—in other words, when the fund’s NAV increases above \$1.

To prevent a stable NAV money market fund from “breaking the buck” on the downside—in other words, when its NAV falls below \$1—a fund’s adviser may step in to support the fund either with a cash infusion or a purchase of securities at an above-market price. The IRS issued temporary guidance during the 2008 financial crisis that it would not challenge the treatment of adviser cash contributions or above market security purchases as generating short-term capital gains to a money market fund.³⁴ At the time, this solution made practical sense since many money market funds had corresponding short-term capital losses to offset the resulting short-term capital gains. Any revisiting of this guidance as a result of the COVID-19 pandemic should consider whether different relief may be appropriate. Such relief could include treating the adviser support as generating no income to the fund (rather than treating such support as resulting in short-term gain).

²⁵ IRC 852(b)(6) and 311(b).

²⁶ IRC 165(i).

²⁷ IRC 165(i) and 165(g).

²⁸ IRC 852(b)(2)(D).

²⁹ Treas. Reg. 1.852-4(b)(2).

³⁰ IRC 305(b)(2); Special basis allocation rules apply to a rights offering under IRC 307 and Treas. Reg. 1.307-1.

³¹ [KPMG COVID-19 Global Tax Developments website](#); See ICI letter to IRS requesting that the IRS encourage treaty partners to provide investors with temporary relief measures including accepting 2019 (recently-expired) certificates of tax residence and accepting electronic copies of documents and electronic signatures (March 25, 2020).

³² IRC 852(b)(2)(D) and IRC 562(b)(1)(A).

³³ A provision that permits the fund manager to limit or halt redemptions in times of financial stress.

³⁴ Revenue Procedure 2009-10, 2009-2 IRB 267.

5

Assess the impact of market conditions on portfolio holdings and transactions

There are several actions to consider with respect to a RICs' portfolio holdings and transactions as positions become distressed or nonperforming as a result of COVID-19.

Nonaccrual for stated interest, original issue discount (OID) and market discount: A RIC may need to continue to accrue (and report) interest income on a nonperforming loan, notwithstanding the fact that no interest is actually being paid, much like is the case with OID on loans. In certain cases it may not be necessary to accrue interest if the interest is of doubtful collectability or it is reasonably certain that it will not be collected. However, the "bar" to stop accruals for stated interest (and also for OID) is relatively high, and requires an identifiable event, such as the borrower being insolvent or in bankruptcy. Nonpayment, postponement of payment or maturity date, financial difficulties, or insolvency may not be sufficient to support nonaccrual. If interest previously treated as uncollectible becomes collectible, it must be accrued into income at that time.

Where loans are acquired by a RIC at a discount from par, long-term capital gain can be converted into interest income, taxable at ordinary income rates on account of the "market discount" rules. A RIC may not need to accrue market discount for debt that is in default or past the maturity date at the time of purchase (given that there is no period over which to accrue market discount).

Wholly or partially worthless bad debt and security deductions: Again, to sustain a deduction for worthlessness, a debtholder must generally demonstrate that the instrument has no future value (i.e., the borrower is unlikely to financially recover).³⁵ Only worthless securities losses are available for debt securities, which generally include debt issued by corporations or the government and are in registered form.³⁶ Most debt instruments held by RICs are likely to be debt securities.

Debt workouts and restructurings: The restructuring of a loan held by a RIC can result in taxable gain, even though no cash has traded hands and even though economically there is no gain/profit.

In particular, the modification of a loan may be treated as a deemed taxable exchange of the premodified loan for the modified loan. This can occur where, for example, the modification of a loan results in a change in its yield, a material deferral of scheduled payments, a change in the collateral or the addition or removal of a co-obligor, and such change is considered to be a "significant modification" (as defined for tax purposes).³⁷

The amount realized by a RIC on a deemed exchange is equal to the issue price of the modified loan (plus any cash and the fair market value of any other property received on deemed exchange).³⁸ A loan's issue price depends on whether the loan is treated as traded on an established market (which does not necessarily require actual trading)—if so treated, the modified loan's issue price is fair market value and, if not, the modified loan's issue price is likely its stated principal amount.³⁹ As a result, a RIC may experience losses from deemed exchanges of loans treated as traded on an established market and gains from deemed exchanges of other loans. Note that if a deemed exchange of a security qualifies as a recapitalization, gain and loss is generally not recognized (except for gain to the extent of any "boot").⁴⁰

Also, in the case of a foreclosure, the foreclosed-upon property may not produce "good" RIC income or qualify as a "good" RIC asset. Therefore, RICs need to pay close attention to the asset and income qualification requirements to ensure that the foreclosure won't disqualify the RIC.

Passive foreign investment company (PFIC) mark-to-market reversals: RICs generally elect to "mark to market" any stock held in PFICs.⁴¹ The RIC must include in gross income the excess, if any, of the fair market value of the stock at the end of the taxable year over its adjusted basis.⁴² This excess, and any gain recognized on the sale of the PFIC stock, is treated as ordinary income.⁴³

On the other hand, a RIC generally may deduct a loss if the value of its PFIC stock decreases to less than its adjusted basis;⁴⁴ this loss is treated as an ordinary loss.⁴⁵ However, losses in excess of prior mark-to-market inclusions are generally treated as capital losses.⁴⁶

³⁵ IRC 165(g) and 166.

³⁶ IRC 165(g)(2)(C).

³⁷ Treas. Reg. 1.1001-3. Note that a temporary forbearance by the debtholder is generally not treated as a modification.

³⁸ Treas. Reg. 1.1001-1(a) and (g).

³⁹ Treas. Reg. 1.1273-2(b), (c) and (d) and IRC 1274. Loans not treated as traded on an established market include all debt issuances that do not exceed \$100 million.

⁴⁰ IRC 368(a)(1)(E) and IRC 354.

⁴¹ IRC 1296.

⁴² IRC 1296(a)(1).

⁴³ IRC 1296(c)(1).

⁴⁴ IRC 1296(a)(2) and 1296(d).

⁴⁵ IRC 1296(c)(1)(B) and Treas. Reg. 1.1296-1(c).

⁴⁶ Treas. Reg. 1.1296-1(c)(4)(ii).

Counterparty defaults with respect to securities loans. No gain or loss is recognized on the transfer of securities pursuant to a securities loan, provided the lender receives identical securities at the end of the securities loan and certain other criteria are met.⁴⁷ COVID-19's impact may well cause a number of stock and security borrowers to default on their obligation to return identical securities. This raises the question whether those securities loans could result in the recognition of gain or loss.

According to guidance issued by the IRS,⁴⁸ nonrecognition continues to apply if (1) the borrower defaults on the agreement as a direct or indirect result of its bankruptcy and (2) the lender applies the borrower's collateral to purchase identical securities to those originally transferred. So, when dealing with actual or potential counterparty defaults on securities loans, a RIC should review the IRS guidance to determine whether it qualifies for nonrecognition of gains or losses.

We're in this together

As RICs, their advisers, and their shareholders navigate the market and other economic challenges created by COVID-19, it will be important to detect potential issues as early as possible and request any needed guidance or relief. We have found that during this time, Congress, the IRS and Treasury have demonstrated a willingness to work with taxpayers in order to minimize possible long-term or lasting consequences to investors and the capital markets.

We understand that this is fluid environment and intend to provide you with updates on how COVID-19 may impact you and the financial markets, and also issue "deeper dives" into certain topics. We're all in this together and are committed to helping you emerge from these challenging times and getting back to business as usual as quickly as possible.

⁴⁷ IRC 1058(b).

⁴⁸ Revenue Procedure 2008-63, 2008-42 IRB 946. This guidance was originally issued during the 2008 financial crisis and remains in effect today.

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