The Tax Cuts and Jobs Act (the Act), signed into law on December 22, 2017, amplifies the effects of certain deduction limitations as they apply to US-taxpaying individuals and other non-corporate investors in private business development companies (BDCs). A ‘private’ BDC typically raises capital in a private offering that is exempt from registration pursuant to Regulation D under the Securities Act of 1933, as amended (the 1933 Act). Pursuant to Section 67(c) of the Internal Revenue Code of 1986, as amended (the Code), certain expenses otherwise deductible by a regulated investment company (RIC) in calculating its investment company taxable income must be passed through to non-corporate shareholders as miscellaneous itemized deductions if the RIC is not “publicly offered.” These expenses may be deducted by such non-corporate taxpayers only to the extent permitted under the Code.

Historically, miscellaneous itemized deductions have been deductible to the extent that they exceeded 2% of the adjusted gross income of US-taxpaying individual investors. Beginning in 2018, however, the Act provides that miscellaneous itemized deductions are not deductible. As a result, although the requirement for a non-publicly offered RIC to pass through certain expenses has existed since 1986, the Act exacerbates the impact to US-taxpaying individual investors by denying miscellaneous itemized deductions.

A BDC is a specific type of closed-end fund regulated under the Investment Company Act of 1940, as amended, that provides small, typically private, companies with access to capital. Unlike a traditional BDC that is listed on a national securities exchange or a “non-traded” BDC that continuously offers shares of its common stock pursuant to an offering that is registered under the 1933 Act, a private BDC’s common stock is not listed on a national securities exchange and instead shares are sold through private placement offerings to accredited investors similar to other offerings in the private fund space.

The advantages of a private BDC structure include the ability to mirror a private fund’s capital drawdown mechanism in a regulated entity. In addition, like any other BDC, a private BDC can elect to be taxed as a RIC. If the BDC makes this election and adheres to specific requirements regarding asset diversification, source of income and minimum distribution requirements, it can avoid taxation at the corporate-level income tax to the extent it distributes its net income and gains to its shareholders. RIC tax treatment also allows a BDC to act as a corporate blocker for non-US investors that are subject to US federal income tax on effectively connected income (ECI) and for tax-exempt investors that would be subject to US federal income tax on unrelated business taxable income (UBTI). As such, private BDCs often target fundraising efforts to non-US-taxpaying investor audiences.

Nonetheless, private BDCs also target fundraising efforts to US-taxpaying individuals and other non-corporate investors. The Act suspends the ability of US-taxpaying individual investors in “non-publicly offered RICs” to deduct miscellaneous itemized deductions. Under the Code, a “non-publicly offered RIC” is treated as a pass-through entity that must pass through affected expenses (i.e., items that would be miscellaneous itemized deductions to non-corporate taxpayers if such taxpayers incurred such expenses directly).
Under the applicable Treasury regulations, as discussed in more detail below, these expenses are passed through as an additional deemed dividend to affected shareholders and then the shareholders separately take into account their allocable share of the affected expenses as if they were incurred directly. This requirement is not new, but is more relevant given the Act’s limitation on itemized deductions. For tax years before 2018, Section 67 of the Code limited an individual’s ability to take miscellaneous itemized deductions to the extent they were less than 2% of that individual’s adjusted gross income. For tax years 2018 through 2025, miscellaneous itemized deductions are not deductible regardless of the amount. For taxable years beginning with 2026, miscellaneous itemized deductions will be deductible again to the extent they exceed 2% of an individual’s adjusted gross income.

Publicly offered RICs are those RICs that continuously offer securities pursuant to a public offering (under Section 4 of the 1933 Act), those regularly traded on an established securities market, or those held by or for no fewer than 500 persons at all times during the taxable year.

Most RICs (mutual funds, traded BDCs and non-traded BDCs) clearly meet the definition for publicly offered entities; open-ended funds are continuously offered under the 1933 Act while closed-end funds generally are traded on national securities exchanges or offer securities in a continuous public offering that is registered under the 1933 Act. In contrast, since private BDC offerings are not registered under the 1933 Act and their securities are not traded on an established market, they will not be considered publicly offered RICs unless they satisfy the 500-investor threshold.

If the BDC cannot meet the 500-investor threshold, it will be treated as a non-publicly offered RIC. US-taxpaying individuals and other non-corporate investors in a non-publicly offered RIC are treated as if they received a dividend in an amount equal to their allocable share of the affected RIC expenses and if they paid or incurred the expenses directly as Section 212 expenses.

1. Affected investors are US-taxpaying individual investors, persons that compute their taxable income in the same manner as an individual (i.e., trusts and estates), and other pass-through entities that have affected investors.

2. Affected RIC expenses are the aggregate amount of the RIC’s normally allowable deductions (not including certain expenses deductible under other provisions of the Code or Treasury regulations, such as interest) in excess of the amount of expenses for:

- Registration fees;
- Directors’ or trustees’ fees;
- Periodic meeting of directors, trustees or shareholders;
- Transfer agent fees;
- Legal and accounting fees (other than fees for income tax return preparation or income tax advice); and
- Shareholder communications required by law, such as the preparation and mailing of prospectuses and proxy statements.

For example, these provisions may impact an affected investor as follows:

- Assume that a BDC has gross income of $1,000 and total expenses of $300, leaving a taxable income of $700 and a total dividend distribution of $700.
- If $120 of the $300 in total expenses are “affected expenses” as defined above, affected investors will receive a Form 1099-DIV showing $820 of ordinary dividends and $120 of investment expenses.
- The $820 will be reported as dividend income and the $120 will be disallowed in tax years 2018 through 2025. Previously and after 2025, the $120 would qualify as miscellaneous itemized deductions to the extent they exceed 2% of the investor’s adjusted gross income.

Note that a RIC may make a binding election to treat 40% of its normally allowable deductions as affected expenses, and this election may make sense for certain private BDCs depending on total income and the resulting expense calculations. For example, if a BDC expects the management fee owed to its investment adviser to be its highest expense and to make up more than 40% of its total expenses, capping affected expenses at 40% may be appropriate. Various other solutions may be appropriate to minimize impacts on US-taxpaying individual investors.
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