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Internal Revenue Service

Department of the Treasury

U.I.L. no.: 851.04-00

Washington, DC 20224

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This is in reply to a letter dated February 20, 1998, and subsequent correspondence, requesting certain rulings on behalf

of Company. The rulings requested generally concern the application of § 851(e) of the Internal Revenue Code to Company's activities. You have also requested a ruling concerning whether Company can carry forward capital losses and net operating losses generated during C corporation tax years to years following its conversion to a regulated investment company (RIC). In addition, we acknowledge that you have withdrawn one ruling you requested.

FACTS:

Company is a venture capital investment company operating as a business development company under the Investment Company Act of 1940, 15 U.S.C. 80a-1, et seq. (1940 Act). Company was incorporated under State law in Year 1. As of the close of business on Date 1, Company converted from an operating company registered under the Securities and Exchange Act of 1934 to a closed-end, non-diversified investment company under the 1940 Act. On Date 2, Company elected to become a business development company (BDC) subject to the provisions of §§ 55-65 of the 1940 Act. Company files its federal income tax returns on a calendar year basis.

As a BDC, Company functions as an internally managed investment company, the operations of which are conducted by its officers and employees under the general supervision of its board of directors. Company's business objective is to achieve long-term capital appreciation from its investments. Company has invested a substantial portion of its assets in private-development-stage or start-up companies and in the development of new technologies in a broad range of industry segments. Company may also invest, to the extent permitted under the 1940 Act, in publicly traded securities. In addition, Company may participate in expansion financing and leveraged buy-out financing of more mature operating companies. As a venture capital company, Company invests in, and provides managerial assistance to, private companies that, in its opinion, have significant potential for growth.

Company has been taxed under subchapter C of the Code since its inception. However, Company intends to qualify and elect to be taxed as a RIC under part I of subchapter M, effective Date 3.

On Date 4, Company owned appreciated assets that it plans to continue to hold, although it may sell certain of the assets during Years 2 and 3. Company expects that some or all of its assets will appreciate from their valuation as of Date 4. Company represents that as of Date 4, it had capital losses and net operating losses available to carry forward to at least Year 3. Company represents that pursuant to Notice 88-19, 1988-1 C.B. 486, it will elect § 1374 treatment with regard to any

appreciated assets that it holds upon conversion to RIC status.

On Date 5, the Securities and Exchange Commission (SEC) issued Company a certification pursuant to § 851(e). The certification provides that Company, for the fiscal year ended Date 4, was principally engaged in the furnishing of capital to other corporations (Development Companies) which are principally engaged in the development or exploitation of inventions, technological improvements, new processes or products not previously generally available (qualified issuers). At the end of each quarter of Year 4, Development Companies comprised the following percentages of Company's total assets: March 31, a percent; June 30, b percent; September 30, c percent; and December 31, d percent. Company represents that during the period from Date 3 through Date 6, more than 50 percent of Company's assets (by value) consisted of securities of qualified issuers whose securities had been held by Company for 10 years or less.

Company represents that it intended that, on a continuous basis for the period from Date 3 through Date 7, more than 50 percent of Company's assets (by value) would consist of securities of qualified issuers whose securities have been held by Company for 10 years or less.

LAW AND ANALYSIS:

Section 851(a)(1)(B) provides, that a RIC includes any domestic corporation which at all times during the taxable year has in effect an election under the 1940 Act to be treated as a BDC.

Section 851(b)(3) provides that a corporation shall not be considered a RIC for any taxable year unless at least 50 percent of the value of its total assets is represented by cash and cash items (including receivables), Government securities and securities of other RICs, and other securities. However, investments in other securities in respect of any one issuer are limited to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer. Additionally, not more than 25 percent of the value of the corporation's total assets can be invested in the securities (other than Government securities or the securities of other RICs) of any one issuer, or of two or more issuers which the corporation controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses.

Section 851(c)(4) defines value, with respect to non-

publicly traded securities, as the fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies the fair market value shall not exceed market value or asset value, whichever is higher.

Section 851(d) provides that a corporation that meets the requirements of § 851(b)(3) at the close of any quarter shall not lose its status as a RIC because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless the discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.

Section 851(e)(1) relaxes the asset test provided in § 851(b)(3)(A) with respect to a BDC, if the SEC determines and certifies to the Secretary not earlier than 60 days prior to the close of the taxable year of the BDC for which the certification applies that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available. In such case, § 851(e)(1) provides that in the computation of 50 percent of the value of its assets for any quarter of the taxable year, an investment company may include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of the issuer (or of any predecessor company of the issuer as determined under regulations prescribed by the Secretary) for 10 or more years preceding the quarter of such taxable year.

Section 851(e)(2) provides a limitation on the general rule of § 851(e)(1). Under § 851(e)(2), the provisions of § 851(e) shall not apply at the close of any quarter of a taxable year to an investment company if at the close of that quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of that issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close

of such quarter.

Section 851(e)(3) provides that for purposes of § 851(e), unless the SEC determines otherwise, a corporation shall be considered principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by the investment company if at the date of the acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of the securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof.

In this case, Company received the certification from the SEC described in § 851(e)(1) that provides that Company was principally engaged in the furnishing of capital to other corporations that principally engage in the development or exploitation of inventions, technological improvements, new processes or products not generally available for Year 4. The certification is based on the value of assets held by Company at the end of the tax year prior to the year in which Company intends to elect to be taxed as a RIC. If Company relied on receiving a certification from the SEC that would be issued within the last 60 days of the tax year in which it intended to elect to be taxed as a RIC, and did not receive such certification, it is possible that Company would fail to satisfy the asset diversification requirements of § 851(b)(3) for prior quarters of the tax year and thus fail to qualify as a RIC for the tax year. Company resolved this situation by obtaining a SEC certification that is based on Company's assets for the prior (non-RIC) tax year and representing that its assets continued to satisfy the requirements under § 851(e) through the first and second quarters of Company's initial RIC year. Furthermore, Company represented that it intended that on a continuous basis throughout Year 2 more than 50 percent of its assets (by value) would consist of securities of qualified issuers whose securities have been held by Company for 10 years or less. Accordingly, based upon the information submitted and representations made, and absent SEC action to the contrary, we conclude that Company may utilize the provisions of § 851(e) for purposes of satisfying the asset qualification test under § 851(b)(3)(A).

A ruling has been requested concerning the date for determining whether the cumulative income tax basis of securities of any one issuer exceeds 5 percent of the value of Company's assets, for purposes of § 851(e)(1). Section 851(e)(1) and § 1.851-6(b)(1) of the Income Tax Regulations provide, in

relevant part, that a RIC, which for the taxable year meets the certification requirements of § 851(e), may include (subject to the limitations of § 851(e)(2)) in the computation of the 50 percent of the value of its assets under § 851(b)(3)(A) for any quarter of such taxable year the value of any securities of an issuer (whether or not the RIC owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the RIC does not exceed 5 percent of the value of the total assets of the RIC at that time. This rule is a qualification of the 5-percent limitation provided in § 851(b)(3)(A)(ii). Accordingly, under § 851(e)(1), the date for determining whether the cumulative income tax basis of the securities of any one issuer exceeds 5 percent of the value of Company's total assets is the date of the most recent acquisition of any securities of such issuer.

Company has requested a ruling seeking an interpretation of the phrase "principally engaged" for purposes of § 851(e). For a RIC to benefit from the provisions of § 851(e), the SEC must determine (in accordance with regulations issued by it) and certify to the Secretary that certain entities are "principally engaged" in specific activities. Because § 851 places in the SEC the determination of whether entities are "principally engaged" in specific activities, we decline to rule on this matter.

The legislative history of section 851(e) indicates that Congress sought to reduce the impediments to the development of venture capital companies that Congress felt were important for long-run economic progress. Consequently, Congress relaxed the burdens of qualification so that venture capital companies could qualify as RICs. The Congressional intent to ease the qualification burden is exemplified in § 851(e)(3), which creates a 10-year grace period in which the activities of the venture capital company will not affect the classification of the investment company as a BDC, except as otherwise determined by the SEC. The House Report indicates that the investment company which acquires the securities of another company which is then principally engaged in developing a new product may continue, for purposes of this section, to hold such securities for a period of 10 years even though during such period the subsidiary company may be actively marketing the product that it has developed. H.R. Rep. No. 586, 82d Cong., 1st Sess. (1951); 1951-2 C.B. 357, 382.

There is no indication in the Code, the regulations, or the legislative history that would lead to a conclusion that a qualifying BDC would have to requalify to be classified under § 851(e) or get recertified by the SEC as a result of either the acquisition of additional securities of a qualified issuer for purposes of § 851(e) within the 10-year period after the date

securities of the issuer were first acquired or in the event that the issuer is not "principally engaged" on the date of the latter acquisition, absent SEC action to the contrary. Accordingly, absent SEC action to the contrary, for purposes of § 851(e)(3) Company may rely on the initial SEC determination pursuant to § 851(e)(1) that an issuer in which it holds a security investment is principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available (qualified issuer) for a period of 10 years after the date it first acquired any interest in a security of such issuer or any predecessor thereof, as long as the issuer or its predecessor was so "principally engaged" as of the date of such acquisition, without the need for further SEC certification or approval. Also, absent SEC action to the contrary, for purposes of § 851(e)(3), Company may rely on the initial SEC determination issued pursuant to § 851(e)(1) with respect to a qualified issuer that Company is principally engaged in the furnishing of capital to that issuer for a period of 10 years after the date Company first acquired any interest in a security of the issuer or any predecessor thereof, even if Company acquires more securities of the issuer or its predecessor within the 10-year period, without the need for further SEC approval or certification.

Company states that it is possible that following its qualification as a RIC, it will either sell assets and distribute some or all of the proceeds to its shareholders or distribute assets to its shareholders. In either case, such actions may alter the composition of Company's assets so that more than 25 percent of the value of Company's assets are securities of a single issuer. However, as provided in § 851(d), a loss of RIC status resulting from failure of the 25 percent asset test under § 851(b)(3)(B) is predicated on the failure resulting from an acquisition of assets rather than a sale or distribution of assets, which may modify the valuation of the RICs assets. See § 1.851-5, Example 5. Accordingly, provided Company satisfies the 25 percent asset diversification requirement of § 851(b)(3)(B) at the close of any quarter of a taxable year, it will not lose its status as a RIC because of a discrepancy during a subsequent quarter between the value of its investments and the 25 percent diversification requirement of section 851(b)(3)(B) as a result of any disposition of assets, including any dividend or other distribution of assets to its shareholders, unless the discrepancy exists immediately after an acquisition of any security or other property and is wholly or partly the result of such acquisition.

Company has requested a ruling concerning whether its capital loss carryforwards and net operating loss carryforwards from C corporation years can be used to offset Company's § 1374 net recognized built-in gains during Company's § 1374 10-year

recognition period following Company's conversion to RIC status.

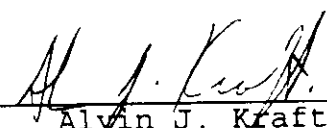
In Notice 88-19, 1988-1 C.B. 486, the Service announced that it would promulgate regulations under the authority of § 337(d) with respect to the net built-in gain of a C corporation's assets in connection with transactions or events that result in the ownership of such assets by a RIC with a basis determined by reference to the C corporation's basis in such assets. The Notice provides that upon conversion to RIC status, the C corporation will recognize any unrealized appreciation in its assets as of the last C corporation taxable year as if the corporation had been liquidated on such date. The Notice further provides that, in lieu of such gain recognition, the regulations will permit taxpayers to elect to be subject to rules similar to the rules of § 1374. To date, the Service has not promulgated any regulations implementing the Notice.

Pursuant to Notice 88-19, Company may elect to be subject to rules similar to the rules applying to S corporations under § 1374. Under § 1374(b)(2), an S corporation's capital loss carryforwards and net operating loss carryforwards from C corporation years can be used to offset its § 1374 net recognized built-in gains. Accordingly, Company's capital loss carryforwards and net operating loss carryforwards from C corporation years can be used to offset Company's § 1374 net recognized built-in gains during Company's § 1374 10-year recognition period following Company's conversion to RIC status.

No opinion is expressed concerning the federal income tax treatment of Company under any section of the Code not addressed herein. Furthermore, no opinion is expressed concerning whether Company otherwise qualifies as a RIC under subchapter M, part I of Chapter 1 of the Code. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Financial Institutions &
Products)

By: 

Alvin J. Kraft
Chief, Branch 1

Enclosures:

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