NIRMA UNIVERSITY
INSTITUTE OF MANAGEMENT
NAAC ACCREDITED 'A' GRADE

SUMMER INTERNSHIP FINAL PROJECT

"Mutual Funds Requirement to qualify for Regulated Investment Company"

in

JPMORGAN CHASE & CO.

Completed in partial fulfillment of the requirement of MBA Program.

Submitted to:

Prof. Deepak Danak

Submitted by:

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JPMORGAN CHASE & CO.

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SUBMITTED TO	Riddhi Desai

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I would like to express my gratitude to all the people who inspired, guided and mentored me while I was doing my project.

To begin with, I would like to thank **Institute of Management, NIRMA University** for giving me an opportunity to link and supplement my experiences with practical learning. I would also like to thank **Prof. Deepak Danak** for mentoring me and guiding me throughout my internship period.

I am grateful to **JPMorgan Chase & Co.** for providing me this internship opportunity which gave me a great chance to improve my skills and learn new things for my professional development. I would like to express my deepest and sincere gratitude towards my managers and my buddy who helped me on my project **"Mutual Funds Requirement to qualify for Regulated Investment Company".** Their suggestions were very helpful to me as it opened up new horizons for my research and helped me to diversify my knowledge spectrum. I perceive this opportunity as a big milestone in my career development.

Sincerely

Aditya Hariyani
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DECLARATION

I, Aditya Hariyani hereby declare that the Project entitled **"Mutual Funds Requirement to qualify for Regulated Investment Company"** submitted by at **JPMorgan Chase & Co.** under the guidance of my managers and buddy as my Summer Internship Project is my original work and the interpretations drawn therein are based on material collected by myself.

Aditya Hariyani
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EXECUTIVE SUMMARY

JPMorgan Chase & Co. is a leading global financial services firm with assets of $2.69 trillion and operations in more than 100 countries. The firm is a leader in investment banking, financial services for consumers and small business, commercial banking, financial transaction processing, asset management and private equity. A component of the Dow Jones Industrial Average, JPMorgan Chase & Co. serves millions of consumers in United States and many of the worlds prominent corporate, institutional and government clients under its J.P. Morgan and Chase brands.

The project is a result of the work done for JPMorgan Chase & Co. from April to June 2020 for a period of 9 weeks.

The objective of the project was to develop the understanding of the US Mutual Fund Industry and find out the requirements for the funds to qualify as an Regulated Investment Company (RIC) and develop some hypothetical examples of the Mutual Funds fulfilling those requirements. And also try to explore the intent of the regulators behind setting up these requirements.

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PART B

Introduction

I was given a **research based project** related to the Mutual Funds Industry of US. I was required to give an overview of the Mutual Fund Industry in US and do the in depth analysis and find out what are the requirements of Mutual Funds to qualify as an Regulated Investment Company (RIC) under the Investment Company Act 1940 as per the laws and provisions made by the Internal Revenue Service (IRS: Tax Authority of US). In addition to this, I need to develop the specific hypothetical examples of financials of a mutual fund meeting those criteria of the Act. I was also required to list down the consequences of not meeting the criteria of an RIC and the tax implications for the fund.

Utility of the Study

This project helped me to develop my understanding and knowledge towards the Mutual Fund Industry and how they fulfill their requirements to get the status of RIC.

It also helped me to find out the intent of the regulators behind each of the 3 broad requirements (gross income, diversification and distribution).

In addition to the above, it also helped to find out the provisions or the laws which can be modified in order to fulfill the intent of the regulators and make it more investment friendly.

Success Measure

- Understand and study atleast 3 regulations impacting an RIC from IRS.
- Clear demonstration of analysis output and presentation to the business.

Methodology

- **Approach:** The approach adopted for this research based project **was a mix of qualitative and quantitative.** As, I researched about the various laws and the sections of IRS related to RICs and Mutual funds which was a qualitative aspect. And I also developed some own hypothetical examples with the help of the financial reports of various mutual funds which was a quantitative aspect.

- **Sources of data:** The research was done purely on the basis of **Secondary sources of data.** Sources were the official website of IRS, Federal Register, and some data was collected from the websites of Big-4 accounting firms.

- **Method of data collection:** As mentioned, data collection was from the secondary sources i.e. **from the documents** like Government Publications, Earlier researches and the financial reports and the performance of the various mutual funds.

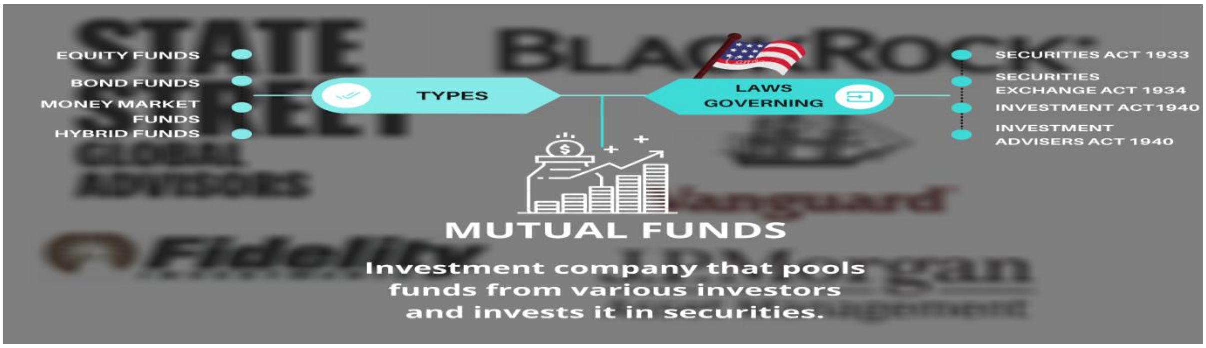
- **Method of data analysis:** The research used **Multivariate and Hermeneutics** methodology for analyzing data. As it derived subjective interpretations from the data and taken into account more than one variables spreaded across different dimensions and areas for analyzing data.

Context of Industry Problem

The research was basically focused on looking out for the reasons why some funds are not qualifying as an RIC. The reason was they were short of either some percentage or late by some days (will be discussed later on). The RIC status is thus protected of the funds by providing them some exemptions in case they fail to satisfy one or the more requirements. Most of these exemptions were added as a result of Modernization Act 2010 of RIC.

Presentation and Analysis of Data

Mutual Fund Industry



Overview of Industry:

US Mutual Funds cover a wide range of asset classes, such as stocks and bonds, as well as market caps, sectors, industries and styles. The funds can be passively or actively managed to achieve short and long term returns. US Funds comprise many large companies in various industries like automobile, technology, healthcare, and the internet. Such funds give a chance to bet on companies like Apple, Amazon, MasterCard, Visa, Alphabet, Microsoft and Facebook. The majority of US mutual fund net assets at year-end 2018 were in long-term mutual funds. With **USD 17.7 trillion assets under management** (expected to reach 23.73 trillion by 2024), the US mutual fund industry remained the largest in the world at the year-end 2018.

US Mutual Funds Net Assets Investment (in 2018)	
Equity Funds	52%
Bond Funds	23%
Money Market Funds	17%
Hybrid Funds	8%

Key Players in US Mutual Fund Markets:

- Blackrock Asset Management
- The Vanguard Group
- JPMorgan Asset Management
- State Street Global Advisors
- Fidelity Investments

Mutual Funds:

- A mutual fund is an investment company that pools funds from many investors and invests it in stocks, bonds, or other securities. The combined underlying securities of the fund are referred to as the "portfolio." Each investor (shareholder) holds shares in the fund that represent part-ownership of the portfolio.
- To qualify for special tax rules available for regulated investment companies, mutual funds are required to distribute their dividend income and capital gains to shareholders on at least an annual basis. This contrasts with other companies as they can either retain earnings or return it to shareholders in the form of dividends (or through a share buyback). Distribution of Mutual funds can be in the form of Ordinary income, Qualified Dividends, Long-term Capital gains, Non-dividend distributions.
- Mutual funds are subject to some degree of risk. In general, stocks (equity funds) tend to be riskier than fixed income securities (bond funds) and short-term debt securities (money market funds), while international investing in any asset market may introduce additional risk factors. Key risk factors are Market risk, Liquidity risk, Operational risk, Credit risk, Concentration risk and Country risk.

TYPES OF MUTUAL FUNDS			
Equity Funds	**Bond Funds**	**Money Market Funds**	**Hybrid Funds**
An equity fund is a mutual fund that invests principally in stocks. It can be actively or passively managed.	A bond fund is simply a mutual fund that invests solely in bonds.	A money market fund is an open-ended mutual fund that invests in short-term debt securities such as US Treasury bills and commercial paper.	A hybrid fund is an investment fund that is characterized by diversification among two or more asset classes. These funds typically invest in a mix of stocks and bonds.
Types of Equity Funds are: Index Funds v/s Active Funds, Growth Funds, Value Funds and Blend Funds, Small, Mid and Large Cap Funds, Domestic or International Funds, Sector/Specialty Funds.	Types of Bond Funds are: Treasury Funds, Agency Funds, Municipal Funds, Corporate Funds, Inflation Protected Funds, International and Global Funds.	Types of Money Market Funds are: Government Money Market Funds, Retail Money Market Funds, and Institutional Money Market Funds.	Types of Hybrid Funds are: Balanced Funds, Asset Allocation Funds, Flexible Portfolio Funds, Alternative Mutual Funds, Income-mixed Funds, Target Date and Lifestyle Funds.

Laws Governing Mutual Funds:

- **Securities Act 1933-** It requires that investors receive specific information regarding securities offered for public sale. This legislation was also known as the "Truth in Securities Act."
- **Securities Exchange Act 1934-** It created the SEC and gave it regulatory authority over the mutual fund industry, along with the stock market and brokerage houses.
- **Investment Act 1940-** It focuses on mutual fund regulations, as well as how investment companies are structured, operate and pursue investment objectives. This act mandates disclosure of a company's financial health and its investment policies.
- **Investment Advisers Act 1940-** Act that defines an investment adviser as any person or firm that for compensation is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.

<u>Background:</u>

Regulated Investment Company (RIC)-

- Regulated investment companies are companies that are regulated by the Securities and Exchange Commission (SEC) and the Investment Company Act of 1940 and have the primary business purpose of investing the assets of owners.
- A regulated investment company (RIC) can be any one of several investment entities who issue securities. It may take the form of a mutual fund or exchange-traded fund (ETF), a real estate investment trust (REIT), or a unit investment trust (UIT).
- A RIC is qualified to pass-through income under **Regulation M** of the IRS, with the specific regulations for qualifying as an RIC delineated in U.S. code, title 26.

Regulation M of IRS	Regulation M, also known as Subchapter M, is an Internal Revenue Service (IRS) regulation that allows regulated investment companies to pass taxes from capital gains, dividends and interest distributions onto individual investors.

- The purpose of utilizing **pass-through or flow-through income** is to avoid a double-taxation scenario as would be the case if both the investment company and its investors paid tax on company generated income and profits. The concept of pass-through income is also referred to as the conduit theory, as the investment company is functioning as a conduit for passing on capital gains, dividends and interest to individual shareholders.
- The only income tax imposed is on individual shareholders. Regulated Investment Companies do not pay taxes on their earnings.

Internal Revenue Source (IRS):

- The Internal Revenue Service (IRS) is a U.S. government agency responsible for the collection of taxes and enforcement of tax laws (such as the wash sale rule).
- Established in 1862 by President Abraham Lincoln as the Bureau of Internal Revenue and was disbanded after income tax laws were repealed following the Civil War. Then the 16th Amendment was ratified in 1913 and the IRS was subsequently recreated. The agency operates under the authority of the United States Department of the Treasury, and its primary purpose includes the collection of individual income taxes and employment taxes. The IRS also handles corporate, gift, excise and estate taxes, including mutual funds and dividends. People colloquially refer to the IRS as the "tax man."
- The Internal Revenue Service is organized around divisions that focus on particular constituents. There are four divisions: one deal with individual taxpayers, another with small businesses, another with mid- to large businesses, and one deals with nonprofits. These operational divisions focus on routine activities like processing tax returns, communicating with taxpayers, conducting audits, and collecting taxes. Around these four divisions, other departments deal with a range of services which include information technology, criminal investigations, and various support services for the entire agency.

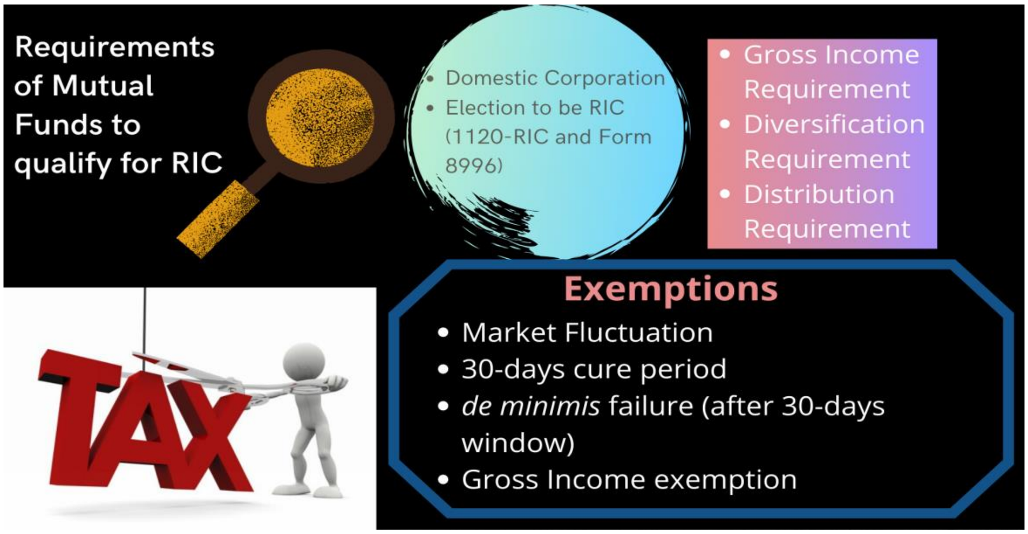
Investment Companies Act, 1940:

- In response to the two major economic events Stock Market Crash of 1929 and the resulting Great Depression, Congress wrote into law the **Securities Act of 1933** and the **Securities Exchange Act of 1934** in order to regulate the securities industry in the interest of the general public. And this gave birth to the SEC and now commonplace items, such as quarterly filings and prospectuses.
- In order to get the general investing public interested in investing in open-end mutual funds and closed-end funds, Congress wrote up the Investment Company Act of 1940 and passed on **22 March, 1940** and gave power to the SEC to enforce its attributes. The Act defined what a mutual fund was and it was here that the modern mutual fund industry really took shape.

- The bill was designed "**to mitigate and eliminate the conditions which adversely affect the national public interest and the interest of investors.**" It does this in several ways. First, all investment companies must register with the SEC. Secondly, each investment company must have a board of directors, and 75% of those board members must be independent or not affiliated with the fund's activities. This was designed to protect investors and provide impartial oversight of the fund.
- In terms of actually operating the fund, the Investment Company Act of 1940 requires that funds limit the use of leverage and must include a cash buffer—in the case of mutual funds—for those investors wishing to redeem their shares at any time. In addition, funds under the Act must disclose their structure, financial condition, investment policies and other objectives to investors via quarterly reports and updates. The **N-SAR form**—which holds all of this information as well as expense ratios and other operating facts—can be accessed free of charge through the SEC's online EDGAR database.
- After the Great Recession and Credit Crisis of 2008/2009, the Dodd-Frank Act of 2010 added some extra regulations to the original Investment Company Act of 1940. Most of the new regulations focus on hedge fund oversight as well as provisions for financial advisers recommending mutual and hedge funds. Again, the new Act was designed to limit systemic risk within the investment company world.

Registered Investment Company	Regulated Investment Company
A mutual fund or other investment company that is registered with the SEC. Registered investment companies are required to report their policies and financial conditions, much like a publicly-traded company. Most investment companies in the United States must register with the SEC; they are regulated by the Investment Company Act of 1940.	An investment company that does not pay taxes on its earnings. Mutual funds and closed-end investment companies are both regulated investment companies. RICs are able to escape corporate taxes because they profit from investments by shareholders and do not have any real operations. They are therefore able to pass profits to shareholders and avoid double taxation. In order to qualify as an RIC, a company must derive at least 90% of its profits from investment activities.

REQUIREMENTS FOR MUTUAL FUNDS TO QUALIFY FOR RIC:



- **Domestic Corporation Registered under the 1940 Act: Section 851 (a)** provides that RIC is any domestic corporation that:

> - At all times during the taxable year is registered under the Investment Company Act of 1940 as a management company or UTI or has in effect an election under the 1940 Act to be treated as a business development company.
> - Is a common trust fund or other similar fund excluded by **Section 3(c)** 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 3(c)	Section 3(c) of the Investment Company Act excludes certain other issuers like broker-dealers, charitable organizations, pension plans and church plans from the definition of investment company.
Section 584(a)	For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity.

- **Election to be an RIC:** A domestic corporation that meets certain conditions must file Form 1120-RIC if it elects to be treated as a RIC for its current taxable year. The election is made simply by filing a federal income tax return on Form 1120- RIC. And to be certified as a qualified opportunity fund, the corporation must file **Form 1120-RIC** and attach **Form 8996**, even if the corporation had no income or expenses to report.

1120-RIC	Use Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies, to report the income, gains, losses, deductions, credits, and to figure the income tax liability of a regulated investment company (RIC) as defined in section 851(b).
Form 8996	Use Form 8996 to certify that the corporation or partnership is a qualified opportunity fund (QOF). It is also used to annually report whether the QOF met the investment standard during its tax year or not.

- **Gross Income Requirement**: A fund must derive **at least 90% of its gross income as stated in Section 851(b)(2)** each taxable year from:

1)

- Dividends and Interest
- Payments with respect to Security Loans
- Gains from sale of securities and foreign currencies.
- Other income (Gains from Options, Futures or Forward contracts)

2) Net income derived from an interest in **QPTP**

QPTP	A publicly traded partnership (PTP) is a type of limited partnership wherein limited partners' shares are available to be freely traded on a securities exchange. In order to qualify as a PTP, 90% of the partnership's income must come from "qualifying" sources as outlined by the IRS above.

- **Diversification Requirement:** At the end of each quarter of the RIC's tax year as per **Section 851(b)(3)**:

Atleast 50% of its assets must be invested in

- Cash and cash items (including receivables);
- Government securities;
- Securities of other RICs; and
- Securities of other issuers, except that the investment in a single issuer of securities may not exceed 5% of the value of the RIC's assets or 10% of the outstanding voting securities of the issuer.

No more than 25% of the value of assets should be invested in the securities of

- A single issuer (excluding government securities or securities of other RICs);
- Two or more issuers controlled by the RIC and engaged in the same or related trades or businesses; or
- One or more qualified publicly traded partnerships.

- **Distribution Requirement:** **(As per Section 852(a)(1))** A fund that satisfies all the above requirements qualifies to be a RIC. To qualify for the pass-through treatment of Subchapter M, however, a RIC also must distribute to its shareholders for each taxable year at least 90% of the sum of its "investment company taxable income" which generally consists of:

    - Net Investment Income
    - The excess of net short-term capital gain over net long-term capital gain.
    - Net gains and losses from certain foreign currency transactions, all determined without regard to the dividends-paid deduction plus its net interest income excludable from gross income under **Section 103(a).**

Section 103(a)	Gross Income does not include interest on any local or state bond except arbitrage bonds, bonds not in registered form and private activity bond which is not a qualified bond.

For these and other purposes, **Section 852(b)(7)** says that dividends and other distributions that a RIC declares in the last quarter of any calendar year, are payable to shareholders on 31 December of that year or earlier (and if not paid they are recorded to be paid in this year only) and this also applies when dividend are actually paid during January of the following year. A RIC that does not satisfy the distribution requirements will be subject to taxation as a C corporation. (This has no restriction on holding assets and has to pay taxes).

- **Exemptions: (as per Section 851(d))**

30 days Cure Period

- If a fund fails to satisfy a diversification requirement at the close of any quarter is wholly or partly the result of an acquisition. The fund has 30 days after the close of the quarter in which to cure the failure.

Market Fluctuation Exception

- If a fund fails to meet a diversification requirement due solely to market fluctuations, distributions, or redemptions, rather than wholly or partly because of an acquisition, the fund will not be disqualified if it had satisfied both diversification requirements at the close of the first quarter of the first taxable year for which it elected to be a RIC.

Gross Income

- When RIC doesn't derive 90% of its gross income from qualified sources then an exemption is provided to RIC. It does not have to pay taxes on its full gross income instead 1/9th of qualified sources income is deducted from unqualified sources income to derive at the taxable income : **RIC Mod Act,2010**

***de minimis* failure (after 30 days cure window)**

- If the assets no more than 1% of the value of RIC assets or $10 million caused the failure then those assets should be disposed off to qualify for the test or should pass the test within 6 months from the last day of the quarter in which failure was identified.
- And in case of the reasonable cause of the failure, assets causing failure should be disposed off and a tax of 35% (current rate) on net income should be charged : **RIC Mod Act,2010**

Scenarios:

1. **ABC Infrastructure Fund –** It seeks total return through growth of capital and current income. The Fund primarily invests in equity securities of publicly traded infrastructure companies listed on a domestic or foreign exchange, throughout the world, including the United States. **Net Fund Assets= $ 195.87million.**

REQUIREMENTS FOR FUND TO BE AN RIC:

- **Domestic Corporation-** As per Section 851(a), the Infrastructure Fund is registered as an open-end Management Company for all the taxable years under Investment Companies Act 1940. The fund is also classified as Diversified Investment Company under Investment Companies Act 1940. It has 4 classes of shares- Class A, Class C, Class Y, Class I.

- **Election to be RIC-** The fund uses Form 1120-RIC to file federal Income Tax Return to report the income, gains, losses, deductions, credits, and to figure the income tax liability of the fund as defined in section 851(b).

- **Gross Income Requirement-**

Sources	Amount ($)	Total ($)
Dividend and Distributions	4,953,461	
Interest	-	
Gain from foreign currencies	2,664,188	
Less: Return of Capital Distribution	(2,572,846)	
Gross Income		**5,044,803**
Here 90% of Gross Income= 4,540,322. So, the amount is more than the 90% of Gross Income. So, as per the conditions below this requirement is fulfilled.		

a.) Atleast 90% of Gross Income should come from Dividend, Interest and Gain from Foreign currencies and other income (options, futures).
b.) Net Income derived from an interest in QPTP.

- **Diversification Requirement-** To meet this requirement there are two conditions which needs to be satisfied.

  a) Atleast 50% of the value of the assets must be invested in Cash and Cash Items, Government Securities, Securities of other RICs, Securities of other issuers, except that the investment in a single issuer of securities may not exceed 5% of the value of the RIC's assets or 10% of the outstanding voting securities of the issuer.

Assets	**Amount($)**	**Total($)**
Investment in Securities	220,436,486	
Cash	5,259,822	
Dividend and Interest Receivable	771,700	
Receivables for investment sold	1,161,360	
Prepaid expenses	34,343	
Total Assets		**227,663,711**

50% of Total assets= $113,831,855.5. And total of Investments and Cash= $225,696,308 which is more than 50% of total assets.
And Some Asset Holdings of the Fund are – TC Energy Corp (4.8%), Xcel Energy Inc (4.8%), Entergy Corp (3.4%), etc. This satisfies the 50% asset requirement of the fund.

  b) No more than 25% of the value of assets should be invested in securities of a single issuer (excluding govt. securities or securities of other RICs), two or more issuers controlled by RIC.

We can see the Top Asset Holdings of the fund. Each company has investment less than 25%. So, this satisfies the second condition of this requirement also. Hence, diversification requirement is satisfied.

As, all the above conditions are satisfied, **the ABC Infrastructure Fund qualifies to be an RIC** under Investment Companies Act, 1940. Hence, it qualifies to avoid federal income tax.

- **Distribution Requirement-**

NET INVESTMENT INCOME	
Details	**Amount (in $)**
Total Investment Income	**5,044,803**
Expenses: Investment Advisory Fees	1,753,937
Administration Fees	309,518
Distribution Fees (Both A and B Classes)	80,313
Registration Fees	71,583
Transfer Agent Fees	67,557
Audit and Tax Services	63,484
Custodian Fees	47,176
Trustees Fees	30,924
Fund Accounting Fees	26,265
Legal Fees	20,932
Miscellaneous	13,301
Insurance	11,079
Reports to Shareholders	9,848
Interest Expense	3,268
Total Operating Expenses	2,509,185
Less: Expenses Reimbursed by Investment Adviser	(159,071)
Net Expenses	**2,350,114**
Net Investment Income	**2,694,689**

FUND TAXABLE INCOME	
Details	**Amount($)**
Net Investment Income	2,694,689
Excess of Short term capital gains over Long term capital gain	2,344,335
Gains and Losses from Foreign currency transactions	(85,257)
Total Fund Taxable Income	**4,953,767**

Distribution to Shareholders’	
Share Class	**Amount($)**
Class A Shares	243,373
Class C Shares	207,263
Class Y Shares	2,672,458
Class I Shares	5,219,191
Total Distributions	**8,342,285**

Here, **90% of Fund Taxable Income= $4,458,390.30. Return to Capital=3,462,332.** And **distribution to shareholders' of all asset class= $8,342,285** which is more than 90% of fund taxable income. So, this requirement is fulfilled. Hence, RIC is now eligible for Pass through treatment of Subchapter M under IRS.

Ordinary Income	Capital Gain Net Income	Total Distributions
$4,879,953	$8,109,910	$8,342,285
Here, **98% of Ordinary Income= $4,782,353** And **98.2% of Capital Gain Net Income= $7,963,931.** As, we can see that 98% of Ordinary Income and 98.2% of Capital Gain Net Income is distributed to shareholders'. Hence, RIC qualifies to avoid the excise tax for the fund (which is 4% to the extent it fails to distribute the income).		

Here, ABC Infrastructure Fund intends to continue to meet the requirements of the Internal Revenue Code of 1986, as amended, applicable to RIC and to distribute substantially all of its taxable income to its shareholders. Therefore, **no federal income or excise tax provision is required.**

2. **Center Coast PQ Midstream Focus Fund-** It seeks maximum total return, with an emphasis on providing cash distributions to shareholders. The Fund primarily invests in "midstream" MLPs, which are issuers generally engaged in the treatment, gathering, compression, processing, transportation, transmission, fractionation, storage and terminalling of natural gas, natural gas liquids, crude oil, refined products or coal. **Net Fund Assets= $929.21 million.**

REQUIREMENTS FOR FUND TO BE AN RIC:

- **Domestic Corporation-** As per Section 851(a), The Focus Fund is registered as an open-end management company for all the taxable years under Investment Companies Act 1940. The fund currently offers 4 classes of shares: Class A shares, Class C shares, Class I shares, Class Y shares.
- **Election to be RIC-** The fund uses Form 1120-RIC to file federal Income Tax Return to report the income, gains, losses, deductions, credits, and to figure the income tax liability of the fund as defined in section 851(b).

- **Gross Income Requirement-**

Sources	Amount ($)	Total ($)
Distributions from MLPs	144,707,704	
Dividend and Distributions	48,564,134	
Dividend from Money Market Fund	398,839	
Less: Return of Capital Distribution	(173,053,546)	
Gross Income		**20,617,131**

Here 90% of Gross Income= 18,555,417.9. So, the dividend and distributions are more than the 90% of Gross Income. So, as per the conditions this requirement is fulfilled.

- **Diversification Requirement-** To meet this requirement there are two conditions which needs to be satisfied.
  a) Atleast 50% of the value of the assets must be invested in Cash and Cash Items, Government Securities, Securities of other RICs, Securities of other issuers, except that the investment in a single issuer of securities may not exceed 5% of the value of the RIC's assets or 10% of the outstanding voting securities of the issuer.

Assets	Amount($)	Total($)
Investment in Securities	2,316,306,582	
Receivables for fund shares sold	6,345,612	
Receivables for investments sold	3,532,428	
Interest and Dividend receivables	318,023	
Prepaid expenses	130,103	
Total Assets		**2,326,632,748**

50% of Total assets= $1,163,316,374. And total of Investments in Securities = $2,316,306,582 which is more than 50% of total assets.
And Some Asset Holdings of the Fund are –MPLX LP 8.4%, William Cos Inc 9.7%, etc. As more than 5% of the value of total assets is invested in security of single issuer, it does not qualify the 50% asset requirement test.

b) No more than 25% of the value of assets should be invested in securities of a single issuer (excluding govt. securities or securities of other RICs), two or more issuers controlled by RIC.

As we can see that more than 25% of assets are invested in security of single issuer. The fund has acquired more than 25% of assets in Enterprise Product Partner LP and the fund remained invested in this asset for more than 30 days after one quarter. So, the exception related to diversification requirement does not hold true. Hence, this requirement is not fulfilled.

Hence, Center Coast PQ Midstream Focus Fund **does not intend to qualify as an RIC**, therefore it is taxed as a Corporation. As a corporation, **the Fund is obligated to pay federal, state and local income tax** on taxable income. The Fund's net deferred tax asset balance is continued to be completely offset by a full valuation allowance. The Fund is currently using an estimated tax rate of 1.22% for state and local tax.

The Fund's income tax provision consists of the following:

Details	**Amount ($)**
Deferred tax expense (benefit): Federal	(46,385,799)
State	(1,697,250)
Change in Valuation Allowance	48,083,049
Total Deferred Tax Expense	**$ -**

Tax Implications of RIC:

Excise Tax

- As per Section 4982(a) of IRS, an RIC is charged a non-deductible **excise tax of 4%** to the extent it fails to distribute : 98% of Ordinary Income, 98.2% of its capital gain net income and 100% of certain other amounts (prior year shortfalls).

Dividend Deduction

- The RIC is allowed a deduction for dividends it pays to its shareholders. This deduction is applicable to distributions made in taxable year, distributions according to Year-End Dividend Rule and to Spillover Dividend.
- And an investment company not satisfying the dividend distribution requirement is entitled to 85% dividend received deduction on its holdings.

Excluding Net Capital Gain

- Net capital gains are taxable to the extent they are undistributed. And RIC can pass through this gain to shareholders by paying "Capital gain Dividends". The long term nature of gain is identified by how long RIC held the investment which generated gain not by how long a shareholder held the RIC's shares.
- Under section 852(b) (3), a RIC is taxed at the flat rate of 25% on the excess of net long-term gain over net short-term loss to the extent that such gain is not paid out as a capital gain dividend.

Net Operating Capital Loss:

This NOL is carried forward by the companies in future to offset the future profits and reducing the tax liability of the business. As per the **Tax Cuts and Jobs Act**, 2017 of IRS, the NOL carryforwards are limited to 80% of each subsequent year's net income. In addition to this, Act removed the 2-year carryback provision of NOL except for some farming losses.

But now as a response to **COVID-19**, the new **CARES Act** of IRS helps in a big way. For the years 2018, 2019 and 2020; NOL carryback of 100% is allowed to the prior five tax years. Further for these years, NOL can be fully used to offset the taxable income rather than 80% allowed earlier. For tax years beginning after 2021, taxpayers will be eligible for 100% NOL deduction arising before 2018 and 80% deduction arising after 2017. A RIC now will be permitted to carry capital losses forward for an unlimited period.

Conclusion:

Regulators (IRS) Intent while setting the criteria of Requirements

Intent behind Diversification Requirement

- Regulators require the fund to **earn income and gain from securities.** Therefore, the investment is made in the securities of other RICs, government securities, etc.
- The intent of regulators behind Diversification Requirement was **to diversify the holding of the securities** and the investment of the fund across different types of securities (debt, equity), different locations, different sectors which would give an advantage to the fund in the time of downturn and to remove the concentration of risk and evenly **spread the risk**.
- It also helps in **reducing the risk** of the fund as investment is diversified across different sectors. And within sectors also, investment in the security of a single issuers is not more than 25% of RIC's asset. So, if a particular firm gets affected by the risk it doesn't harm the fund much and if particular sector also gets affected, it has least impact as investment is diversified across different sectors.
- Regulators also intended for **ensuring safety** as in case it has some major impact, then 50% requirement criteria ensures that atleast 50% of the assets are invested in Cash and cash related items and Govt. securities which ultimately keeps the investment safe and provides ready liquidity to the fund in case of adverse situations.
- By providing some exemptions to the asset diversification test, regulators aim to **protect a RIC against inadvertent failures** of the asset tests that may be caused solely by fluctuations in the relative values of its assets which otherwise force the investment company to pay the taxes as a normal corporation.

Intent behind Gross Income Requirement

- Regulators require the fund to **earn income and gain from securities.** Therefore, income comes from the interest earned, gains from sale of securities.
- Gross Income requirement which says 90% of gross income should be derived from qualified sources. So, regulators intent behind this was to make the **RIC eligible for various deductions and carryover treatments** provided to earnings from qualifying sources of RIC.
- This would **reduce the tax liability** of the fund as it has to pay taxes just on the income earned from other unqualified sources which cannot be more than 10%. By doing this, it ultimately motivates the fund to increase their earnings from the qualified sources which provides them benefit.
- And in case the fund fails, regulator **protects the RIC status** of the fund by not charging it as a C corporation but providing them a cure to meet the requirement, $1/9^{th}$ of the qualified income subtracted from the unqualified source.

Intent behind Distribution Requirement

- The regulators intent behind Distribution requirement was **the revenue raiser** as it aims it increasing the distributable income for the RIC which otherwise gets charged excise tax on the undistributed amount. Moreover, to make it more acceptable regulators increased the capital gain income distribution from 98% to 98.2% to increase their revenue as deductions on most items distributed can be claimed by RIC.
- Other Intent was to **reduce the tax liability** as distributions in excess of earnings are treated as return of capital distribution which is generally not taxed.
- Other intent was **Deduction benefit** to the RIC as they can record the dividend which is actually paid in the following year as paid on the last date of present year and claim the deduction in the present year. Hence, we can say the fund should distribute more income as it reduces the tax liability and deductions could be claimed which would ultimately increase the revenue of the fund.

Other measures by Regulators (IRS) to smoothen the system:

Taxpayer Advocate Service (TAS)	IRS provides RIC with **Taxpayer Advocate Service (TAS)** which is an independent organization under IRS and it protects the fund from the immediate threat of adverse action, problem causing financial difficulty for the business.
CARES ACT for NOL	As a response to **COVID-19**, IRS implemented the **CARES ACT** for Net Operating Loss (NOL) which permitted the carryback treatment of upto 5 year and carryforward for indefinite period and increased the deduction amount from NOL to 100% from 80%.
Installment Facility	IRS provides the **installment facility** to those RIC who cannot pay the full tax owed in one go. This helps in reducing the chances of fraud and defaults.
Carryover Treatment for Charity Contribution	IRS promotes Charity Contribution by providing the RIC with the **carryover treatment** for Charity Contribution. The deduction claimed cannot be more than 10% of taxable income and IRS does not provide immediate deduction but it can be carry forward to the next 5 years which reduced the tax liability.

Possible Alternatives Identified (Suggestions):

Return of Capital Distribution

- In my opinion there should be separate provision for Return of Capital Distribution as after using dividend to the extent we earned profit for distribution, we deploy Return of Capital for distribution purpose to the shareholders. As this is like giving back them their own money instead of passing on the gains to them (which is the sole purpose of Distribution requirement to be eligible for pass through income). So, I believe Return of Capital should not be used for distribution purpose instead we should focus more on increasing earnings from foreign currency transactions and from net investment income.

Spillback Dividends

- Another thing in my opinion is that the spillback dividends should be treated in the same year by both the RIC and the shareholders. These are dividends which are declared in the last quarter of the calender year and RIC can record it as paid for the present year in order to claim the deduction and actually pay it in the next year. This causes a mismatch in timing when RIC claims a deduction and when shareholders pay taxes on them

Diversification Failure

- In my opinion to make the provision more investor friendly, a change can be made to the exemption given to diversification requirement. So, I would suggest giving the RIC 2- months window to fulfill the requirement if just 25% requirement got voilated (not because of fluctuation in market prices, acquisition).
- For instance, RIC's investment in securities is 30% and other is less than 5%. So, here not satisfying both 50% asset and 25% requirement test.
- RIC should be given a 2-month window to reduce the gain if any. As gains from these securities would be the qualified sources of income and they would be anyway distributed to the shareholder and raise the revenue of the fund.

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PART C

Learnings:

It was purely an amazing experience to work for the World's top most Investment Bank. As I was a fresher and this was my first corporate exposure so my internship was full of learning. I was a part of Funds Management Department under the Corporate and Investment Bank (CIB) segment of the firm. The training modules prior to project made me well verse with the basics of finance and gave me a better exposure to the field of finance which further helped me alot when I started my project. Then from the project, I got immense knowledge of the mutual fund industry of US and how they make out their earnings as I did extensive research on this field only. The project also enhanced my knowledge about the various sections, laws and the provisions of the tax authority of US and gave me a better understanding of how the following criteria have been set up by the IRS. Further by understanding the project part, I was able to develop some hypothetical examples of the fund satisfying those criterias which enhanced by analytical and logical skills. I also learnt the time management and people management skills as I have to complete the better work as per the timelines and also work with the team on some of the parts which was an important part of my internship.

I have developed skills and competenices that not only align to the learning objectives of the course module but are also useful for my future employment. I was able to match the theoretical knowledge gained in the institute to the practical skills acquired during the internship period.

Last but not the least, I learnt a fair deal about the business of this leader of the banking industry and its method of differentiating itself from the competition.