WACHOVIA SECURITIES

CLOSED-END FUNDS

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How a Dividend Tax Cut Would Work for Closed-end Funds

The Composition of Closed-end Fund Distributions

The possibility of a dividend tax cut has raised questions regarding the tax treatment of the distributions made by closed-end funds. Because the terminology used to describe distributions by closed-end funds can be misleading, this report describes the actual composition of distributions made by closed-end funds and how they are likely to be affected by a change in the taxation of corporate dividends.

Taxation of Closed-end Funds and Their Distributions

As a registered investment company, a closed-end fund does not itself pay taxes as long as it passes through to its shareholders almost all of its realized capital gains and income earned. Although some investors might refer generally to the payments they receive from closed end funds as "dividends," they are actually distributions that reflect the payment to the closed-end fund's shareholders of long-term capital gains, short-term capital gains, interest income and/or corporate dividends. To make matters more confusing, interest income, short-term capital gains and corporate dividends are collectively referred to as "ordinary dividends," while long-term capital gains are referred to as "capital gain dividends."

While any type of fund may distribute capital gains (short or long), interest income and corporate dividend income are typically tied to the specific asset class held by a fund. For example, fixed-income closed-end funds typically make distributions that consist of interest income, while some equity funds typically make distributions that include a significant amount of dividend income.

Composition of a Closed-end Fund's Distribution[1]		
Capital Gain Dividends		Any fund
Ordinary Dividends	Interest Income[2]	Mainly among fixed-income funds
	Corporate Dividend Income	Mainly among equity funds
	Short-term Capital Gains	Any fund

In order to understand what portion of a closed-end fund distribution would benefit from a dividend tax cut, investors will need to focus on the composition of the closed-end fund's distributions. Only the corporate dividend income portion would benefit from a dividend tax cut.

Potential Tax Change

President Bush's dividend tax cut proposal has already generated significant controversy, and the prospects for passage this Congress are unclear. However, as closed-end fund investors monitor these developments, it is important to bear in mind that any potential benefit will be limited to the portion of a distribution that is treated for tax purposes as corporate dividend income. For some funds, such as equity funds, this portion may be significant and the tax effect could be substantial. For other funds, such as municipal bond funds, there would be no tax effect. (In addition, the relative size of these tax effects could easily be offset by other market factors.)

1099-DIV Forms

Under current rules and practice, closed-end funds' year-end 1099-DIV forms typically state the amounts of the distribution for the tax year that represent capital gains and ordinary dividend[3]. (Funds may provide more detailed information in a press release or online.) If the proposed changes to the taxation of corporate dividends are adopted, closed-end funds may be required to break down the ordinary dividend portion into interest income, corporate dividend income and/or short-term capital gains.

Additional information is available upon request.

[1] *Some closed-end funds, in particular equity funds with a distribution policy or fixed-income closed-end funds exposed to currency risk, may return capital. While return of capital is not taxable, the fund's cost basis is adjusted by the amount of the return of capital.*
[2] *The interest income of municipal closed-end fund is tax-exempt.*
[3] *The 1099-DIV form also states the amount of non-taxable return of capital, if any.*