Closed-End Fund Distribution Tax Character Mistakes And Misunderstandings

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Closed-end funds are an excellent way to generate income, use as arbitrage exploiting premiums/discounts or gain exposure to illiquid assets that wouldn't normally work in traditional mutual funds or ETFs. They can provide access to assets that retail investors wouldn't normally have the chance of owning. However, one of the most important things is to understand the tax situation behind these funds if you are holding them in a taxable account. Some of the confusion comes from what the funds are required to provide themselves, and some are from data aggregators that just can't get it right.

Some of these are topics we have discussed in the past - though they are worth revisiting for new investors, or just a great refresher for veterans too. It can feel like going through a labyrinth when starting out with CEFs. However, once you realize some of these misconceptions of CEFs, it can be a lot less confusing. Especially once you start to realize where to find the most accurate information.

(Source)

Return Of Capital Confusion

Going to return of capital (ROC) right off the bat as it is the number one most confusing - and is often the primary source of the rest of the confusion that this article is based on. As some investors think all ROC is bad no matter what.

As we've discussed in the past, there can be several reasons why funds distribute out ROC. So determining if it is destructive or harmless is important.

One of the simplest ways to know if a fund is utilizing destructive or constructive ROC is to watch its NAV. A growing NAV over a period of time indicates that the fund is earning its distribution. An eroding NAV will indicate that they really are merely returning your investment to you, without earning these through unrealized gains or elsewhere. An eroding NAV isn't a sustainable long-term investment and an investor will eventually see distribution cuts.

> Some funds utilize an options strategy. This includes some of the more popular funds in this category from Eaton Vance (EV). These include Eaton Vance Tax-Managed Buy-Write Opportunities Fund (ETV), Eaton Vance Tax-Managed Global Buy-Write Opportunities Fund (ETW) and Eaton Vance Tax-Managed Buy-Write Strategy Fund (EXD).
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> Through writing calls on indexes, they can generate losses. Writing options against an index can result in losses since they are cash-settled. Meaning that if an index rises too high the premium collected will not be enough to offset the cash payment that will be due, or the amount that it will take for the fund to close the position will be greater than the premium received. In theory, losses can be unlimited for option index writing since an index can go to infinity. In practice, we know this won't typically happen for obvious reasons. Also, the managers can roll the

> positions or close them, just like any other option position for an individual.
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> This is also where the other side of the portfolio can benefit. If an index is going to be rising significantly, then chances are the underlying positions within the fund are also rising in at least a similar upward trajectory. After all, these funds own a lot of what the index they are writing on reflect as well. That's how ETV and ETW can generate losses, even when the underlying positions might be rising and accumulating unrealized gains. If they never sell the unrealized gains to turn them into realized gains, then that is exactly where they remain.

The other common factor for a fund where we see ROC is in the MLP structure. MLPs regularly distribute out ROC themselves as they have a lot of physical assets that they can utilize depreciation against the gains. Of course, it has been harder to decipher between destructive ROC or good ROC with MLP funds as they've been the worst-performing for several years now. Though 2021 is looking promising so far.

Finally, it could be as simple as not realizing enough gains of the underlying portfolio. Instead, leaving the appreciation as unrealized. A good example of this is BlackRock Science and Technology Trust II (BSTZ). In 2020, this was the top-performing CEF with returns near 100% for the year. Quite impressive! Yet, they classified ~12% of the distributions as ROC. In this case, it definitely wasn't destructive - they just hadn't realized enough of their underlying gains to classify them all as long-term capital gains.

(Source - BlackRock Tax Notice)

Another BlackRock Fund, BlackRock Utilities, Infrastructure, & Power

Opportunities Fund (BUI) was in a similar situation. The fund performed really well and the NAV rose for the year. Yet, they are also showing around 12% in ROC for their distribution.

Section 19a Notices Confusion

One of the most confusing, I believe, is section 19a. It sounds like a fancy form, but it really is quite simple. If a fund *believes* that any distribution contains anything other than income from the fund, they are required to provide this notice.

The problem is it is just simply an estimate. There is no way of knowing exactly what the fund's distribution classifications will become by the end of the year. It can vary wildly sometimes as well. Some funds are closer to their estimates, and others are really off. This can be due to some unforeseen circumstance or some drastic changes in a portfolio that they didn't anticipate.

Remember, a CEF is just holding a basket of investments. This means that whatever dividends, distributions or gains that they get themselves, will also affect the classification to the CEF holder as well. The easiest example is what we mentioned above if an MLP fund is collecting a lot of ROC that will translate into the CEF itself paying a lot of ROC.

Let's look at an example of this. Below is from John Hancock Tax-Advantaged Dividend Income Fund (HTD). Their fiscal year-end is October 31st. In September their section 19a was showing that they were estimating 13% of the distribution as ROC.

(Source - HTD September Section 19a)

For prior months, it was bouncing around too; sometimes including

ROC and sometimes not. July's section 19a was around a similar ROC amount at 14%. One month before that though, in June 2020 it was showing no ROC and only income and gains.

Below is what was estimated as of October 2020, as provided by the section 19a.

(Source - HTD October Section 19a)

So one would probably imagine that it should be pretty close by this time. After all, it is the last month of the fiscal year. Well, one would be wrong if they thought that. The final tax classification showed about 25.5% as long-term capital gains and ordinary income the remainder.

(Source - HTD Annual Report)

In fact, if you go to the official tax release excel file that they provide (really hard to read and not as presentable as many other fund sponsors) you will notice that most of this was considered qualified dividend income. Which is a great thing to help lower tax obligations. However, the total capital gain distribution was more around 26.54%, with the rest being ordinary income.

Data Aggregator Confusion

This one is a big one that I see a lot. Investors asking questions on the tax character and referring to CEFConnect. To be quite frank, I've never once seen these numbers be accurate. That is the challenge if someone can show me once where CEFConnect's data is correct on the distribution history.

To be fair, I use CEFConnect an absolute ton. It is a great website with many tools geared specifically towards CEF investors. It is tremendously helpful and I would recommend the site and tools for any investor into CEFs. However, there is some information that you just cannot utilize from a data aggregator.

The biggest one here being the distribution history, as that is the topic of the day. I would also say the "portfolio characteristics." That is a discussion for a different day though.

It is also worth noting before showing some examples that CEFConnect simply gets its information from Morningstar. So once you see it is wrong on CEFConnect, you will know it is wrong from Morningstar.

So, what's the problem. Let's look at some examples using BSTZ as just the first. Below is an image grab from CEFConnect's distribution history.

(Source - CEFconnect)

We already presented the distribution breakdown above for BSTZ. As we can clearly see, for the year it is not matching up. They are showing around 66% of the distribution would be ROC. We know that it officially, from BlackRock themselves, is around 12%.

Now let's look at HTD. We know that their fiscal year-end doesn't line up with calendar year-end, so to be the fairest we will look at distribution breakdown between October 2019 and October 2020.

(Source - CEFconnect)

Once again, we are seeing a considerable amount of ROC, that wasn't in the final classification. We also see here that it doesn't even match with the section 19a notices that they filed. That always made me chuckle a little bit, as I really don't know where they are getting their information (making it up out of thin air?)

Now here is another good example. We will use Nuveen Real Estate Income (JRS). They actually run the CEFConnect platform, but again, the information comes from Morningstar.

(Source - CEFconnect)

This time, JRS did classify some of its distribution as ROC last year. From the above, though it would appear that 22% was ROC, 28% as long-term capital gains and the remaining ~50% as ordinary income.

As you can probably assume by now, this would be wrong again.

(Source - Nuveen Tax Notice)

Conclusion

The bottom line here is that ROC isn't always destructive, there are reasons that funds might be distributing ROC. It could have to do with their investment strategy, the types of distributions they are receiving themselves or just not realizing the underlying gains and keeping them unrealized.

For section 19a notices, the bottom line is that they are supposed to help investors, but it is only an estimate. The final tax classification cannot be known officially until year-end. Not even the fund sponsor publishing these section 19a forms know. Unfortunately, this is just one of those things that the SEC requires, without actually seeing the real-world consequences. Good intentions, but causing some confusion.

Finally, using a data aggregator as a source for tax classifications often isn't correct. ***We need to go to official sources from the funds themselves on distribution taxation. Official tax characteristics will not be known until year-end.*** Right here are the most important sentences of this whole article, if you take away nothing else, take away that.

Data aggregators can be great, but we have to know what information to use and what can be ignored. In the case of distribution history, I've never once seen the data be correct come year-end. I've even noticed that it regularly doesn't match the section 19a notices that funds provide as well. That can be a big shock if someone is holding a sizeable position and they are anticipating ROC or capital gains.

In the case of ROC, an investor isn't taxed in that year and instead it reduces the cost basis of the investment. Now imagine if you get hit with a big tax bill you weren't planning. Long-term capital gains can also be beneficial to investors as they are typically taxed at a lower rate, lowering an investor's tax burden.

I know the above is a lot of numbers and reading, but these are important points for investors holding in a taxable account.