

# Return of Capital Distributions Demystified

CLOSED-END FUNDS | 2025

Most closed-end funds pay regular monthly or quarterly distributions to their shareholders. Like open-end mutual funds, they are required after each year-end to provide an **IRS Form 1099-DIV** to every shareholder who received distributions during the year stating the distributions' federal income tax character. Fund distributions may be characterized variously as: (1) dividends,<sup>1</sup> (2) capital gain distributions or (3) **nondividend** distributions, also known as **return of capital** distributions.

What does it mean to receive a nondividend, or return of capital, distribution? Different from taxable income and capital gains distributions, *return of capital distributions are not subject to current tax*. Instead, the tax cost basis of each shareholder receiving a return of capital distribution is reduced by the amount of the distribution, which increases the amount of capital gains (or decreases the capital loss) to be recognized when a shareholder sells his or her shares. Because of the generally more favorable tax consequences of return of capital distributions, funds that are managed for after-tax returns may

seek to maximize the amount of distributions treated as return of capital by, for example, selling securities they hold at a loss to offset gains on sales of appreciated positions.

A common misconception about return of capital distributions is that they are somehow less legitimate, or less valuable, than other fund distributions. In this thinking, dividends and capital gains distributions are based on fund returns, and therefore earned, while return of capital distributions are not based on fund returns, and therefore unearned. A key distinction that may elude those who take this view is the difference between *return of principal* (economic concept) and *return of capital* (tax concept). While they sound like the same thing, they are not. A simple example to illustrate:

## A few key takeaways to remember:

- Return of capital is a tax concept, not an economic concept.
- Return of capital distributions are not subject to current tax. Compared to ordinary dividends, they offer the potential advantages of reducing (to long-term capital gains rates) and deferring (until year of sale) shareholder taxes.
- The tax character of a fund's distributions tells little about whether the distributions are supported by fund returns—dividends and capital gains distributions may be unearned and return of capital distributions can be earned.
- The best measure of whether a fund has earned its distributions is the change in its NAV net of distributions. Regardless of how distributions are characterized, if a fund's NAV increases, the fund earned its distribution. If not, the fund did not earn its distribution—the economic concept of return of principal.

“Fund ABC begins a year with a net asset value (NAV) of \$10.00 per share. It has a total return on its investments of 5% (\$0.50 per share) and distributes 7% (\$0.70) during the year. Its NAV falls by 2% (\$0.20) to an ending value of \$9.80.<sup>2</sup>”

<sup>1</sup> Fund dividend distributions may include non-qualified ordinary dividends (taxed at ordinary income tax rates), qualified dividends (taxed at rates applicable to long-term capital gains) and exempt-interest dividends (not subject to regular federal income tax).

<sup>2</sup> This example is hypothetical and for illustrative purposes only. It does not consider transaction costs (such as brokerage commissions) associated with reinvesting distributions via open market purchase. It is not representative of any actual closed-end fund product, nor does it represent actual results. Actual results will vary, perhaps to a significant degree.

Investors in Fund ABC would appropriately consider \$0.50 of the Fund's distribution to be "earned" (i.e., supported by Fund returns) and \$0.20 of the distribution to be "unearned" (i.e., in excess of Fund returns). This is true regardless of the character of the distribution for tax reporting purposes.

Perhaps surprisingly, the tax character of a fund's distributions reveals very little about whether distributions are supported by the fund's total return. Returning to our example, Fund ABC may have invested in fixed-income securities yielding net income of 7% (supporting 7% dividends) and lost 2% in principal value due to bond defaults, trading losses or markdowns in position values. Alternatively, Fund ABC may have invested in growth equity securities generating 7% in net realized long-term capital gains (supporting 7% capital gains distributions) and lost 2% in principal value as net unrealized losses on its portfolio investments increase relative to net unrealized gains. In both cases, Fund ABC distributed more than its 5% total return for the year, causing its NAV to fall by the amount of the excess distribution (2%).

As demonstrated by the foregoing, fund distributions characterized as dividends or capital gains may not necessarily be supported by fund returns, and may represent economic return of principal. But can the opposite be true for return of capital distributions? Yes, that can be the case. A second example to demonstrate:

So if the tax character of a fund's distributions cannot be relied upon to reveal whether or not a fund has earned its distributions, how can a shareholder determine this important information?

It's actually quite simple, and requires only information that is readily available to every fund shareholder. Look at the change in a fund's NAV per share (net of distributions) over the course of a year: if NAV has increased, the fund earned more than it distributed. If NAV has gone down, the fund distributed more than it earned. Said differently, if a fund's total return based on NAV has exceeded its distribution rate for the year, it earned its distribution. If not, the opposite. Pretty straightforward, right?

"Fund XYZ begins a year with an NAV of \$10.00 per share. It realizes a total return on its investments of 9% (\$0.90 per share) and distributes 7% (\$0.70) during the year. Its NAV rises by 2% (\$0.20) to an ending value of \$10.20. If Fund XYZ has no net investment income (because deductible fund expenses equal or exceed income and net realized short-term gains) and no net realized long-term gain (because realized long-term gains are fully offset by net realized losses), then its distributions are all characterized as return of capital. Fund XYZ can achieve this outcome (desirable from a shareholder tax perspective) by, for example, owning growth equity securities that appreciate by an aggregate 9%, and matching net realized gains on appreciated securities sold with net losses realized by selling portfolio positions that have declined in value.<sup>3</sup>"

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