

IRS TEMPORARILY ALLOWS CLOSED-END FUNDS TO LIMIT THE AMOUNT OF CASH THEY ARE REQUIRED TO DISTRIBUTE

On January 7, 2009, the Internal Revenue Service (the “IRS”) released Revenue Procedure 2009-15 (the “Revenue Procedure”), which temporarily allows closed-end investment funds, when paying distributions subject to a shareholder “cash or stock” election, to cap the total amount of cash to be distributed at a level as low as 10 percent of the total distribution.

Closed-end funds that are regulated investment companies (“RICs”) for tax purposes are required to distribute at least 90 percent of their annual income and gains to shareholders as taxable distributions. Such funds are allowed to retain any net long-term capital gains but are subject to corporate tax on the amount retained.

Generally, a closed-end fund distribution subject to a shareholder election to receive either cash or stock of the fund is considered fully taxable to shareholders, even to those shareholders that receive only stock. For closed-end funds, a distribution payable only in stock is generally not considered a dividend for tax purposes.

The Revenue Procedure permits a closed-end fund to limit the amount of cash the fund will distribute to not less than 10 percent of the amount of its total distribution. If too many shareholders elect to receive cash, each shareholder that elected to receive cash may be paid only a proportionate share of the cash available for distribution, with the remainder of each such shareholder’s distribution being made in the form of shares of the closed-end fund of equivalent value. The Revenue Procedure provides that, under these circumstances, the entire amount of the distribution will be regarded as taxable.

The Revenue Procedure expands and liberalizes prior IRS practice regarding dividend distributions. The IRS previously had issued private rulings to real estate investment trusts and to a closed-end fund, allowing them to limit the amount of cash distributed to shareholders to 20 percent of the distribution in a manner similar to that permitted by the Revenue Procedure. The Revenue Procedure permits a closed-end fund to limit the total amount of cash the fund will distribute to 10 percent of the entire amount distributed.

A closed-end fund must meet several requirements in order for the Revenue Procedure to apply. Specifically, the closed-end fund must be publicly traded on an established securities market in the United States, and the fund must calculate the number of shares to be received by any shareholder as close to the payment date as practicable, based upon a formula utilizing market prices that is designed to equate the value of the number of shares to be received by a shareholder with the amount of cash that would otherwise have been received instead. With respect to any shareholder participating in a dividend reinvestment plan, such plan may apply only to the extent that, in the absence of the plan, the shareholder would have received cash under the cash limitation permitted by the Revenue Procedure.

In order for the Revenue Procedure to apply to a distribution, the distribution must have been declared on or after January 1, 2008, and the distribution must be declared with respect to a taxable year ending on or before December 31, 2009.

Other Considerations for RICs

There are several non-tax considerations for closed-end funds concerning the limitation of the cash portion of a distribution. Under Section 23(b) of the Investment Company Act of 1940, closed-end funds that are RICs are precluded from selling their common stock at a price below current net asset value. A distribution to all common shareholders should, however, be permitted by the exception to this prohibition in Section 23(b)(1). Nonetheless, depending on the size of the non-cash component, such a distribution could be very dilutive to the closed-end fund. Careful Board consideration is warranted. In addition, a closed-end fund's dividend reinvestment plan may require amendment to comply with the Revenue Procedure and to limit the cash portion of the distribution. Finally, since most closed-end fund shares are held in street name, there are apt to be mechanical issues with obtaining needed shareholder elections of cash or shares after appropriate notice.

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If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com), James R. Brown (212-728-8287, jbrown@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

January 15, 2009

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