

Internal Revenue Service

Number: **200703009**

Release Date: 1/19/2007

Index Number: 3406.00-00, 6041.03-00,
6041.05-00, 6045.00-00,
6049.01-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:

CC:PA:APJP:B01

PLR-111299-06

Date:

October 12, 2006

Section 3406 -- Backup Withholding

3406.00-00 Backup Withholding

Section 6041 -- Information at Source

6041.03-00 Fixed or Determinable Gains, Profits, or Income

6041.05-00 Payments Specifically Included

Section 6045 -- Returns of Brokers

6045.00-00 Returns of Brokers

Section 6049 -- Returns Regarding Payments of Interest

6049.01-00 Reportable Interest

LEGEND:

Taxpayer =

Fund =

X =

Y =

Years 1-5 =

Year 6 =

\$A =

Dear :

This letter responds to the letter dated January 31, 2006, submitted on behalf of the Fund requesting the following rulings:

1. Settlement payments from the Fund to mutual fund investors are not subject to information reporting under section 6041 of the Internal Revenue Code, except in the case of payments made directly to participants in tax-qualified retirement plans.
2. Settlement payments from the Fund to mutual fund investors are not subject to information reporting under section 6045.
3. Settlement payments from the Fund to mutual fund investors are not subject to information reporting under section 6049.
4. For purposes of meeting any obligations it may have under section 3406 as a payor of "reportable payments," the Fund need not solicit taxpayer identification numbers (TINs) from the individuals to whom it will make distributions. The Fund may obtain the TINs from the mutual funds or tax-qualified plans in which such individuals held accounts, or from transfer agents performing services for the funds or plans.

FACTS

Based upon the facts and the representations made, the Fund is a qualified settlement fund (QSF) as described in section 468B and the regulations thereunder. The Fund was created in Year 6 to resolve an administrative proceeding brought by the Securities and Exchange Commission (Commission) against X and Y relating to investment advice provided to certain mutual funds. The proceeding related to the inadequate or nonexistent disclosure of X's policies allowing market timing trading of mutual fund units (units) and to the oversight, monitoring or management of trades of such units (trades) from at least the middle of Year 1 through the middle of Year 5.

In an Order Instituting Proceedings (OIP) directed at X and Y, the Commission alleged that X made various material omissions and misrepresentations regarding market timing of funds and that X and Y committed certain other wrongful acts relating to trades and holdings in the units. Improper market timing impairs the value of mutual fund shares by depressing their net asset value. Improper market timing also generates excess trading volume and thus increases the advisory fees mutual funds must pay to investment advisors such as X. Thus, the conduct of X and Y resulted in damage to the investors and a loss of capital. The Commission, based on the improper conduct described above and the resulting damage to mutual fund investors, sought profit disgorgement and civil penalties. After investigation and negotiations, X and Y agreed to pay \$A to settle the Commission's claims. Pursuant to section 308(a) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7246), the OIP authorized a "Fair Fund" for

the disgorgement and penalty components of the sum X agreed to pay, thus permitting both components to be paid to injured investors.

Those investors holding units of the mutual funds during any portion of the time period specified in the OIP will be eligible to receive distributions from the Fund. The distributions will be based on the Commission's orders. The amount available for distribution is the net settlement pool, which includes the sum of \$A (the amount transferred by X into the Fund) and the amount of net income earned by the Fund. Investors will be allocated portions of the net settlement pool. The Commission's orders provide that investors will first receive their proportionate share of losses suffered by the mutual funds due to market timing and then a proportionate share of advisory fees paid by the mutual funds that suffered such losses during the period of market timing.

LAW AND ANALYSIS

Ruling 1. Section 1.468B-2(l)(2)(i) of the Treasury Regulations provides that, in general, distributions by a QSF are subject to certain information reporting and withholding requirements. Treas. Reg. § 1.468B-2(l)(2)(ii) provides that a QSF must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant. The regulations further provide that, for purposes of sections 6041(a) and 6041A, if a QSF makes a distribution on behalf of a transferor or a claimant, the fund is deemed to make the distribution to the recipient of that payment or distribution in the course of a trade or business. In such a situation, the QSF is also deemed to have made the distribution to the transferor or claimant. See Treas. Reg. § 1.468B-2(l)(2)(ii)(C)-(D).

Section 6041 requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year, to file an information return with the Service and to furnish an information statement to the payee. Treas. Reg. § 1.6041-1(c) provides that payments are fixed when they are paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. Treas. Reg. § 1.6041-1(a)(2) requires a payor to report section 6041 amounts on Form 1099. Thus, payments that are not fixed or determinable are not subject to information reporting under section 6041.

Amounts a taxpayer receives to restore a loss of capital are not income except to the extent that the payment exceeds the taxpayer's basis in the injured property that is the subject of the payment. *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944). Fund payments to investors for losses the mutual funds suffered from market timing appear to constitute compensation for a loss of capital. Market timing

permitted by X depressed the net asset value of mutual fund shares; compensation from the Fund will compensate, at least partially, for this damage. Because the Fund has no access to the investors' tax basis in their mutual fund accounts and has no need or occasion to collect information on tax basis, the Fund is unable to calculate how much of this compensation for mutual fund losses constitutes fixed or determinable income. Accordingly, the Fund has no information reporting obligations under section 6041 for such compensation.

As noted above, a portion of the Fund payments will compensate investors for improper advisory fees paid by the mutual funds to X. Although such payments may constitute gross income to investors, the Fund cannot (due to limitations on its data collecting authority) determine whether the payments will constitute gross income to investors. The payments, therefore, are not "fixed or determinable" income within the meaning of the regulations under section 6041. Accordingly, subject to the exception noted below regarding distributions to qualified retirement plan participants, the Fund has no information reporting obligations under section 6041.

The Fund states that it may make a certain number of distributions directly to participants in tax-qualified retirement plans. Section 72 of the Code controls the taxation of such distributions, and the distributions must be reported on Form 1099-R pursuant to section 6041, subject to the \$600 reporting threshold set forth in section 6041(a) and Treas. Reg. § 1.6041-1(a)(1)(i)(B).

Ruling 2. Treas. Reg. § 1.468B-2(l)(2)(ii) provides that a QSF must make a return for a distribution to a claimant if one or more transferors would have been required to make a return had that transferor made the distribution directly to the claimant.

Section 6045(a) provides generally that every person doing business as a broker shall, when required by the Secretary, make a return in accordance with such regulations as the Secretary may prescribe. Section 6045(c) defines the term "broker" to include a dealer, a barter exchange, and any other person who (for a consideration) regularly acts as a middleman with respect to property or services. The regulations further define the term "broker" to mean a person that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others. See Treas. Reg. § 1.6045-1(a)(1).

Treas. Reg. § 1.6045-1(c)(2) provides generally that a broker shall make an information return for each sale effected by the broker in the ordinary course of the broker's trade or business. Treas. Reg. § 1.6045-1(a)(9) defines a sale as any disposition of securities, commodities, regulated futures contracts, or forward contracts for cash, and as including redemptions of stock, retirements of indebtedness and entering into short sales.

The Fund's payments to investors do not result from a "sale" as that term is defined above. The Fund, therefore, has no information reporting obligations under section 6045 with respect to these payments.

Ruling 3. Section 6049(a) provides that every person who (1) makes payments of interest aggregating \$10 or more to any other person during any calendar year, or (2) receives payments of interest as a nominee and who makes payments aggregating \$10 or more during any calendar year to any other person with respect to the interest so received, shall make a return according to the forms or regulations prescribed by the Secretary.

Section 6049 (b)(1) provides that the term "interest" includes interest on any obligation issued in registered form or of a type offered to the public, other than any obligation with a maturity (at issue) of a year or less which is held by a corporation. Pursuant to section 6049(b)(1)(e), "interest" also includes interest on deposits with brokers (as defined in section 6045(c)).

The Fund distributions in the present case do not relate to deposits with brokers or obligations issued in registered form, and do not otherwise qualify as interest within the meaning of section 6049(b). This is so even though interest earnings have accrued on the funds to be paid to investors, from the time X paid such funds to the Fund. The Fund distributions to investors relate to violations of securities law and compensation for financial harm, not to obligations issued in registered form or other instruments that generate interest as section 6049 defines that term. Accordingly, the Fund has no information reporting obligations under section 6049 regarding its distributions to the investors.

Ruling 4. Section 3406(a)(1) generally provides that, in the case of any reportable payment, if (A) the payee fails to furnish his or her TIN to the payor in the manner required, (B) the Secretary notifies the payor that the TIN furnished by the payee is incorrect, (C) there has been a notified payee underreporting of interest and dividends, or (D) there has been a certification failure (collectively referred to as "payee failures"), then the payor shall deduct and withhold from such reportable payment a "backup withholding" amount totaling 28% of such payment.

Section 3406(b)(1) provides that the term "reportable payment" means any reportable interest or dividend payment and any other reportable payment. Section 3406(b)(3) provides that the term "other reportable payment" includes any payment of a kind, and to a payee, required to be shown on a return under section 6041 or 6045.

In light of Rulings One through Three above, only direct payments by the Fund to participants in tax-qualified plans will be reportable payments subject to backup withholding under section 3406. In order to meet its obligations under section 3406, and to include TINs on information returns it must provide for these reportable

payments, the Fund plans to obtain those TINs from one of the following sources: the plan administrator, the mutual funds in which the participants invested, or the transfer agents that provide services to the administrator or mutual funds.

Obtaining the TINs in this manner should prove more reliable and less burdensome and costly to the Fund than soliciting the TINs from the plan participants. In light of the authority it has been granted by the Commission, the Fund will be able to obtain the TINs of plan participants from the plan administrators, mutual funds or transfer agents. The Fund will not be required to solicit TINs from the participants for purposes of applying the backup withholding rules of section 3406.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Furthermore, this letter expresses no opinion about information reporting requirements for Fund distributions that are not made directly to the injured investors. This letter also expresses no opinion about the income tax consequences to investors of Fund distributions.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Carol P. Nachman
Acting Senior Technician Reviewer
Office of Associate Chief Counsel
Procedure and Administration
(Administrative Provisions and Judicial Practice)

Enclosure (1)