



February 6, 2008

The Honorable Christopher Cox  
Chairman  
U.S. Securities & Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Subject: Taxation of SEC Fair Fund Payments

Dear Mr. Chairman:

As you are well aware, the Commission has collected more than \$3.2 billion in civil penalties from at least 29 investment companies, other financial institutions, and certain individuals as a result of recent enforcement actions involving mutual funds. Through the Commission's Fair Fund process, outside Independent Distribution Consultants and Fund Administrators have been selected to develop and execute plans to distribute these monies to millions of individual investors.

This has been a complicated and time-consuming endeavor. The Commission and its staff are working very hard to ensure that these distributions are handled properly and reach as many aggrieved investors as possible. CMFI applauds the efforts that been made so far by the many participants in this process. CMFI also congratulates the Commission on the creation of its new Office of Collections and Distributions. This new Office will ensure more uniformity and efficiency in distributing funds to investors.

One of the issues that has not been properly addressed in the Fair Fund process is the tax treatment of distribution payments at the individual investor level. Each of the investment companies involved in a Fair Fund distribution has approached the Internal Revenue Service (IRS) for private letter rulings on the tax treatment of these payments. Unfortunately, the conclusions in these rulings have greatly complicated what should be a simple process.

In general, the IRS is taking the position that these distributions will either require an adjustment to an investor's cost basis or be treated as taxable income for any investor not in an Individual Retirement Account (IRA) or other tax-deferred investment structure. CMFI has reviewed written statements issued by the Fund and Tax Administrators for three of these Fair Funds.<sup>1</sup> What follows is a summary of how a taxable investor is expected to treat these distributions, according to these written statements.

---

<sup>1</sup> See Pilgrim Baxter Fair Fund Distribution Statement to Eligible Investors, publication date unknown, available at [http://www.pbafairfundsettlements.com/docs/SEI\\_for\\_Website\\_042307v2.pdf](http://www.pbafairfundsettlements.com/docs/SEI_for_Website_042307v2.pdf).

1. Distributions to Compensate for Dilution. For investors who are receiving distribution payments to compensate for dilution attributable to market timing or related activities, the IRS will require each investor to adjust his or her cost basis downward by the amount of the payment.<sup>2</sup> If the payment exceeds an investor's current basis, then the excess over that basis amount will be treated as a capital gain.<sup>3</sup>

2. Distributions to Compensate for Improper Advisory Fees. A number of Fair Funds are also compensating investors for advisory fees that were improperly paid to an investment company. In this case, the IRS looks first to see if a particular fund made a dividend payment in the same year as the allocated distribution payment. A dividend payment that was considered to be ordinary income at the time it was made results in the same tax treatment for any distribution payment meant to compensate for improper advisory fees allocated to that same year.<sup>4</sup> If a dividend payment was not made in the year in question for a particular fund, then the distribution payment requires an adjustment to an investor's cost basis.<sup>5</sup>

While the IRS is probably correct in its analysis of the tax treatment of these distribution payments, this process is going to create an administrative nightmare for the individual investors receiving these payments. It is expected that a great majority of these payments will be between \$10 and several hundred dollars. It seems completely unfair for these investors to have to recalculate their cost basis and also have to figure out if they are responsible for paying tax on a portion of a distribution payment that is deemed to be ordinary income or a short-term or long-term capital gain.

This situation will lead to unintended consequences. An investor receiving a small payment may have to spend more money in professional fees than the distribution amount, in order to have his or her accountant calculate the basis adjustment and the tax due for this payment. Other investors may choose to avoid all of this effort by giving their Fair Fund payments to 501(c) (3) charities. While these investors will receive tax deductions for their contributions, this course of action completely defeats the purpose of Fair Fund compensatory payments.

---

Columbia Fair Fund Distribution Statement to Eligible Investors, publication date unknown, available at <http://www.columbiafairfund.com/pdfs/StatementtoEligibleInvestors2.pdf>; and Banc One Fair Fund Distribution Statement to Eligible Investors, publication date unknown, available at <http://www.settlementbanconeia.com/downloads/BancOneStatementEligibleInv.pdf>.

<sup>2</sup> In most circumstances, an investor's cost basis is the amount that is paid for the mutual fund shares that he or she owns.

<sup>3</sup> For example, if an investor has a cost basis of \$300 and receives a \$400 payment, the cost basis is reduced to \$0 and the investor must report a \$100 capital gain. This gain will generally be a long-term capital gain unless the investor held his or her shares for one year or less.

<sup>4</sup> Several funds are providing charts that summarize the dividend payments made for each fund on a year-by-year basis. For investors in multiple funds within a fund family, allocation decisions will need to be made for Fair Fund payments across different funds and over the period of time the shares were owned.

<sup>5</sup> For advisory fee compensation payments, the investor must treat as a capital gain any Fair Fund payments that exceed his or her cost basis, in a manner similar to the process described above in footnote #3 for payments received as compensation for dilution of the fund shares.

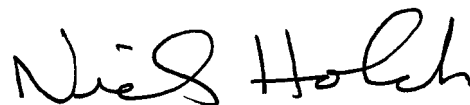
There are millions of mutual fund shareholders and hundreds of funds involved in the Commission's Fair Fund process. As a policy matter, the federal government should treat these payments as nontaxable events and ensure that this distribution payment process does not create unnecessary tax liabilities for individual investors who were harmed by the mutual fund scandals. At the very least, a person receiving a \$50 check should not have to hire an accountant to determine the tax treatment of such a small payment!

It has been a Commission goal to develop a Fair Fund distribution process that maximizes the amount of money that is returned to investors. The complexity of these investor-level tax issues and the unfairness of taxing individuals on these compensatory payments certainly detract from this goal. These problems should be addressed in a manner that focuses on the needs of the individual investor. And, as many of these distributions are now in the process of being sent to investors, time is certainly of the essence.

Even though the Commission does not have jurisdiction over tax matters, the agency should consider making a recommendation to the White House and Congress that Fair Fund payments to individual mutual fund investors be treated as a non-taxable event. Addressing this issue in the manner that CMFI is recommending will not result in a significant revenue loss for the federal government and there will be large and beneficial savings in administrative costs for individual investors.

Thank you for considering CMFI's views regarding the tax treatment of Fair Fund distributions to individual mutual fund investors.

Sincerely,



Niels Holch  
Executive Director

cc: The Honorable Paul S. Atkins  
The Honorable Kathleen L. Casey  
Linda C. Thomsen, Division of Enforcement  
Andrew J. Donahue, Division of Investment Management  
Kristin J. Kaepplein, Office of Investor Education  
and Advocacy  
Richard J. D'Anna, Office of Collections and  
Distributions  
Lynn M. Powalski, Office of Collections and  
Distributions