Notice 2009-17

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LEGAL PROCESSING DIVISION
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From: Gibian (Lau), Karen [kgibian@ici.org]
Sent: Thursday, April 09, 2009 2:20 PM
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Subject: Investment Company Institute Comments on Notice 2009-17
Attachments: Notice 2009-17 - ICI Comment Letter - 4-9-09.pdf

Dear Ms. Potter,

The Investment Company Institute appreciates this opportunity to provide the Internal Revenue Service and the Treasury Department with our comments (attached) on the new cost basis reporting requirements. We applaud the government for turning to these issues so quickly. Crafting workable and equitable regulations will require considerable time and thought, as well as significant cooperation and coordination between the government and stakeholders. We believe that Notice 2009-17 raises many of the most important issues that must be addressed.

The Institute and its members will endeavor to provide the IRS and the Treasury Department with information and assistance at the earliest opportunity. Given the complexity and number of issues raised by the new requirements, we also would be happy to meet with you, at your first convenience and as often as necessary, to discuss cost basis reporting.

We must emphasize, at the outset, that effective implementation of this legislation by the financial services industry will require a herculean effort within a very short time period. Many critically important systems changes cannot be made without a thorough understanding of exactly what firms will be required to do. Binding IRS regulations, in many cases, may be necessary to provide the comfort that firms will need before spending millions of dollars on new systems. Consequently, the need for prompt IRS guidance is acute.

The Institute appreciates the opportunity to comment on this important new reporting requirement. We look forward to discussing it further with the IRS and Treasury Department and will contact the IRS soon to request a meeting. In the meantime, should you have any questions, please contact me.

Regards,

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By Electronic Transmission

April 9, 2009

Clarissa C. Potter
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments on Notice 2009-17

Dear Ms. Potter:

The Investment Company Institute[1] appreciates this opportunity to provide the Internal Revenue Service (the "IRS") and the Treasury Department with our initial thoughts on the cost basis reporting requirements in the Economic Stabilization Act of 2008 (the "Legislation"). We applaud the government for turning to these issues so quickly. Crafting workable and equitable regulations will require considerable time and thought, as well as significant cooperation and coordination between the government and stakeholders. We believe that Notice 2009-17 raises many of the most important issues that must be addressed.[2]

The Institute and its members will endeavor to provide the IRS and the Treasury Department with information and assistance at the earliest opportunity. Given the complexity and number of issues raised by the cost basis reporting legislation, we would be happy to meet with you, at your first convenience and as often as necessary, to discuss cost basis reporting.

We must emphasize, at the outset, that effective implementation of this Legislation by the financial services industry will require a herculean effort within a very short time period. Many critically important systems changes cannot be made without a thorough understanding of exactly what firms will be required to do. Binding IRS regulations, in many cases, may be necessary to provide the

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $9.47 trillion and serve over 93 million shareholders.

[2] Based on discussions with members, we address several other issues not raised by the Notice. For your convenience, the attached Appendix contains a table of contents.

comfort that firms will need before spending millions of dollars on new systems. Consequently, the need for prompt IRS guidance is acute.

I. Background

Our responses are based upon decades of experience with cost basis information provided voluntarily by the fund industry to its shareholders, as well as our detailed understanding of the interactions between fund shareholders, their advisers, and the funds in which they invest. This background discussion summarizes how money and information move between shareholders, financial intermediaries and fund companies.

Shareholders may interact with the fund either directly (with the fund's transfer agent)[3] or indirectly (typically after consulting with a financial representative who works for, or processes trades through, an intermediary).[4] Different parties will know different information, and have different reporting obligations, depending on how the shareholder interacts with the fund.

There are two basic account structures used by mutual funds: individual accounts and omnibus accounts. Individual accounts are held either in the name of the investor or in the name of an intermediary for the benefit of the investor (who is the intermediary's client). For individual accounts held in the name of the investor, the fund knows the shareholder's identity and entire transactional history. For individual accounts held in the name of an intermediary, the fund knows the shareholder's transactional history, but may or may not know the shareholder's identity.[5] An omnibus account is held in the name of an intermediary and is a master account representing subaccounts of multiple investors. For omnibus accounts, the fund does not know the individual identities of the underlying shareholders; the fund knows the transactional history for the omnibus account as a whole, but does not know individual transaction history for each shareholder.

Tax reporting may be done by the fund or by the intermediary where the shareholder's identity and transaction history are known by both; the intermediary will perform tax reporting when only the intermediary knows the shareholder's identity. Typically, tax reporting is done by the last party in the communication chain with the shareholder. For example, the party that initiates an order to redeem fund shares and pays the gross proceeds to the shareholder generally will send the IRS Form 1099-B.

[3] Transfer agents maintain records of shareholder accounts, calculate and distribute dividends and capital gains, and prepare and mail shareholder account statements confirming transactions and account balances, federal income tax information, and other shareholder notices. Some transfer agents also maintain customer service departments, including call centers, to respond to shareholder inquiries.

[4] Intermediaries may include broker-dealers, banks, investment advisors, financial planners, and "fund supermarkets."

[5] In some cases, adjustments or corrections to the shareholder's transaction history that are made by the intermediary may cause the individual transaction history in the fund's records to differ from the intermediary's records. The shareholder's balance, however, remains the same.

For most mutual funds, the vast majority of transactions occur through intermediaries that are participants in the industry utility provided by the National Securities Clearing Corporation ("NSCC").[6] The remaining transactions occur directly with the fund (either by the shareholder or the intermediary).[7]

A. *Activities through the NSCC*

The NSCC has two services for mutual fund clearance and settlement: Fund/SERV[8] and Networking.[9] These automated services for NSCC participants provide secure, efficient, and cost-effective trading, money settlement, and information exchange through dedicated system connections using standardized formats and procedures. Because these systems employ established requirements, timeframes are set so a sender and a receiver know the parameters for sending and receiving trade and account-related information. Knowing the established requirements and timeframes enables both sides to create control points for receipt of data and exception processing for missing data.

1. Individual Accounts through the NSCC

Individual accounts are the most common type of account processed through the NSCC services. These accounts are opened and controlled exclusively by a broker-dealer for the benefit of a single client. The shareholder's identify may be fully, partially, or not disclosed on the fund's account record registered in the intermediary's name for the benefit of the investor. The broker-dealer supports all of the functions necessary for these accounts and thereby maintains the most comprehensive relationship with its client; among other things, the broker-dealer is responsible for tax reporting.

In more limited instances, broker-dealers or other intermediaries will provide some shareholder services on individual accounts, such as processing trades and providing statements, while the fund provides other shareholder services, such as investor accounting and tax reporting. In these instances, the investor may interact with either the intermediary or the fund, or both.

[6] NSCC is a subsidiary of the Depository Trust and Clearing Corporation ("DTCC").

[7] Retail sales of shares in exchange-traded funds or closed-end funds (the shares of which also are eligible for the average cost basis method) occur on stock exchanges; they never flow through the NSCC utilities described in this submission.

[8] Fund/SERV provides a standardized and fully automated platform to process purchase, exchange, and redemption orders, and to settle those orders.

[9] Networking supports the exchange and reconciliation of account information as held on the books of the transfer agent with that held on the books of the intermediary.

2. Omnibus Accounts

For omnibus accounts, the account is opened on the records of the fund in the name of the intermediary. All trade activity for the subaccounts in the omnibus account is aggregated, and the intermediary typically sends one trade through the NSCC to the fund transfer agent each day. The fund does not have any information on its transfer agent system related to the underlying investors or beneficial owners of the subaccounts. The intermediary manages the interaction with the investor and provides all of the related support services, including tax reporting.

B. *Activities Directly with the Mutual Fund*

Transactions conducted directly with the funds may occur over the internet, by telephone, or through the mail. Generally, individual shareholders initiate these transactions; in certain circumstances, an intermediary may be managing or is associated with the account.[10] Trades and money flow for these transactions (although still very secure) do not utilize fully automated mechanisms. Because these transactions typically involve multiple systems and manual intervention to complete, the standards provided by NSCC utilities are not available for these transactions. The timing of the information flow and the form in which data is received, consequently, is less predictable; the need is greater for follow-up contact – between the shareholder, the intermediary, and/or the fund – to resolve problems.

For accounts held directly with the mutual fund, shareholder servicing (including tax reporting) generally is conducted by the fund. In limited circumstances, an intermediary that is associated with the account may provide tax reporting.

C. *Cost Basis Reporting Experiences*

The mutual fund industry has extensive experience with cost basis reporting. The first fund company began providing this customer service in the early 1970s, after the IRS issued regulations to permit the basis of fund shares to be calculated using average cost.[11] A large portion of the industry began providing average cost statements in the early to mid-1990s. Many intermediaries also provide cost basis information (most often using the first-in, first-out method, or "FIFO") to the individuals for whom the intermediary does tax reporting. Anecdotal information suggests that many, if not most,

[10] For example, an investor may open an account through a broker-dealer where the broker-dealer mails an account application and a check typically to the fund transfer agent. In this situation, the account is opened in the name and tax identification number of the investor and the fund complex is the primary point of contact for the investor, including for tax reporting.

[11] The regulations permitting average cost were requested by the fund company that first began providing cost basis information voluntarily.

shareholders calculate cost basis using the data provided.

While cost basis statements are provided routinely today to individuals who redeem their fund shares, there are some limitations to the prevalence and assured accuracy of the average cost data provided. Importantly, funds typically provide cost basis only if all shares are acquired directly from the fund (rather than acquired through share re-registrations, such as for gifts or inheritances). Moreover, cost basis may not be provided on older accounts, particularly if old transaction history necessary to calculate cost basis was purged from automated systems. Those funds that have supplemented this voluntary service by taking cost basis data from customers (or applying default basis assumptions for transfers such as gifts) have no way to verify independently the accuracy of the additional data used. In addition, some funds have not programmed their systems to apply certain basis adjustment rules, such as those addressing wash sales and sales load basis deferrals (discussed below). Finally, most funds only provide average cost to shareholders today and must develop systems to accommodate all cost basis methods.

Other factors affecting the industry's experience include the different systems on which cost basis records are maintained and the limited ability today to transfer cost basis information through the NSCC. At the fund level, cost basis generally is maintained on a system ancillary from the transfer agent system used for general shareholder recordkeeping. The records on these two systems are not integrated easily. Moreover, cost basis data does not move between funds and intermediaries today if shares are transferred through NSCC, because the NSCC functionality to move cost basis information is limited to transfers between broker-dealer firms. No automation exists for account transfers that do not flow through the NSCC processing system. Many significant and costly systems changes must be crafted and implemented to ensure that cost basis information can move efficiently and accurately for fund shares acquired after the Legislation's effective date.

II. Implementation Issues

A. *Communicating Broker Default Methodology and Shareholder Method Elections*

The Institute does not recommend that the IRS issue any guidance regarding cost basis reporting communications with either existing or new shareholders. Individual firms are best equipped to decide what cost basis methodologies provide the optimal balance of costs and benefits for their customers and how to communicate with them regarding the relevant issues and considerations. The IRS has an important role to play, however, in educating taxpayers about the new cost basis reporting rules.

The new cost basis reporting regime will require brokers – a statutorily-defined term that includes funds and their agents[12] – to educate, and communicate extensively with, both existing and

[12] *See* section 6045(c); Treas. Reg. § 1.6045-1.

new customers. Issues to be addressed include the broker's default method, the various cost basis methodologies that may be used by shareholders, and the process (including timing) for making an election to use a cost basis method other than the broker's default method. Different communications will be necessary for existing and new customers.

Existing customers (who acquire their first shares in the fund before the Legislation's effective date) must be contacted by the fund companies or intermediaries regarding the cost basis methodologies for any share purchases made in these accounts after the Legislation's effective date. Funds and intermediaries will establish efficient and cost effective means for notifying customers of the firm's default cost basis method. As part of that process, they will provide customers with the opportunity and means to choose an alternative cost basis method.

New customers, in contrast, will be informed of the broker default method and the available alternatives during the account opening process. Today, a customer opening an account in a fund, either directly or through an intermediary, is asked to make a number of selections regarding the operation of their account; these choices include whether the customer may redeem shares over the telephone, whether the customer may write checks from the account, and whether the customer wishes to make systematic purchases and/or withdrawals. In the future, new customers also likely will be asked whether they would like cost basis calculated using a method other than the broker's default method.

Guidance is not needed regarding how either existing or new customers should be informed of the broker default method and the investor's option to choose an alternative method. Because of the many differences between how various funds and intermediaries communicate with their customers (*e.g.,* by using the internet, by written mailings, or by direct contact with an individual financial representative), no single solution will work best for all. Moreover, no guidance is needed because funds and intermediaries have a very strong incentive to ensure that their customers are adequately informed of their choices and the process for electing a basis method – firms do not want unhappy customers come tax time.

The IRS could be helpful, however, in supplementing the industry's efforts to educate investors about the new cost basis reporting requirements. Educating investors will require a monumental effort. We suggest that the IRS post information about these requirements on its website, develop new targeted publications regarding cost basis, and update existing publications and form instructions.

B. *Broker Default Methodology and Shareholder Method Election Considerations*

The Institute urges prompt resolution of a preliminary cost basis reporting issue that is critical for determining the regulatory framework. Specifically, the government must determine the circumstances, if any, under which a shareholder is *required* to use the basis information provided by the broker with respect to shares in regulated investment companies ("RICs"). This question must be resolved by IRS guidance before fund companies can make final decisions regarding their default methodologies and the process by which shareholders communicate their elections to have basis calculated using an alternative method.

While some may believe that Congress clearly intended that all investors use the cost basis data provided to them under the Legislation, the Institute submits that the statutory changes to sections 6045 and 1012 do not compel this result in the case of RIC shares.[13] The specific uncertainty regarding RIC shares, and the interaction between these two Code sections, arises from a RIC shareholder's present-law ability to calculate cost basis under two methods (FIFO and average cost), that do not have to be selected at the time fund shares are redeemed.

Cost basis, both before and after the Legislation, is calculated under section 1012. Nothing in that section, or in the reporting rules of section 6045, expressly requires that taxpayers calculate cost basis under section 1012 using the information provided pursuant to section 6045. Indeed, Congressional staff repeatedly said during the legislative process that the Legislation would "not change substantive law." The Legislation affected "reporting only."

For securities other than RIC shares, the interaction between sections 6045 and 1012 generally is quite clear and provides the result that some believe Congress intended. Specifically, section 6045(g)(2)(B)(i)(I) provides that the adjusted basis required to be reported under section 6045(g)(2)(A), for securities other than RIC shares, shall be calculated using the FIFO method unless the customer notifies the broker by means of an adequate identification. The default cost basis methodology under Treas. Reg. section 1.1012-1(c)(1) also is FIFO; the result is that a taxpayer selling shares other than those of RICs *must* compute cost basis under section 1012 using FIFO, unless an adequate identification was made, pursuant to Treas. Reg. section 1.1012-1(c)(2), at the time the stock was sold. Therefore, if a shareholder complies with current regulations, the basis number used by that shareholder to compute gain or loss generally should be the same number reported on Form 1099 by the shareholder's broker.

This interaction also is clear in the case of RIC shares but does not produce the result that Congress may have intended. Specifically, section 6045(g)(2)(B)(i)(II) provides that cost basis for shares in a RIC shall be reported in accordance with the broker's default method, unless the customer notifies the broker that he elects another acceptable method under section 1012. Unlike regular stock, where only two options exist to determine basis (one of which requires a contemporaneous determination), the cost basis of RIC shares may be calculated under three methods: FIFO, specific identification, or average cost. Brokers may choose any default method with respect to RIC shares. As noted above, the default rule for all stock under current regulations is FIFO, unless a shareholder specifically identifies shares to the broker at the time of sale. A RIC shareholder who decides to use average cost, however, is not required to make the election until he files his tax return for the taxable

[13] As discussed below, the cost basis of all RIC shares (including those of mutual funds, exchange-traded funds, and closed-end funds) may be calculated using the average basis method permitted under section 1012.

year in which the RIC shares were sold or redeemed.[14] The interaction of section 6045(g) and current regulations under section 1012 indicates that if a RIC shareholder chooses not to use the default method provided by the broker, he does not have to inform the broker of his selected method; rather, the shareholder can rely upon current law and make that election when he files his tax return by applying FIFO or average cost. Therefore, the shareholder's basis and the broker's reported basis may not match.

To illustrate this issue, assume the broker chooses as its default the FIFO method. Upon its first redemption, assume further that the shareholder does not inform the broker of his elected method, so the broker applies its default. If the shareholder does not want to use FIFO, under current regulations, he could elect to use average cost by indicating such on the tax return filed for that year. If this is permissible, the shareholder's basis information will not match that provided by the broker.

In this scenario, the shareholder and the broker both have complied with the law. Nevertheless, the basis information reported by each will not match, for the current taxable year and all future taxable years. Thus, an initial question that must be addressed is whether the statutory changes to section 1012 and 6045 – which were intended to address only reporting issues – were designed to eliminate a shareholder's existing ability under the section 1012 regulations to elect average cost on the individual's tax return if the fund utilizes a different default method. Likewise, if a fund's default method is average cost, it is unclear whether a shareholder is precluded from utilizing the general FIFO default rule in the section 1012 regulations.

If the government intends to change these long-standing regulations and eliminate a fund shareholder's ability to elect average cost on the tax return or to preclude the use of the FIFO default, they should announce their intention as soon as possible.

1. Guidance if Shareholders are Required to Use Broker-Provided Numbers

The Institute submits that, if taxpayers generally will be required to use the basis information provided by their brokers, the IRS must decide promptly the date by which a shareholder must elect his or her basis method. Several important operational considerations cannot be addressed until this issue is resolved.

a. Time for Electing Specific Identification

The Institute supports the present-law rule, contained in IRS regulations,[15] that prevents specific identification determinations from being made after securities are sold. The tax policy reasons for preventing post-sale specific identifications continue to apply.

[14] *See* Treas. Reg. § 1.1012-1(e)(6)(i).

[15] *See* Treas. Reg. § 1.1012-1(c)(2).

We do recommend, however, that the regulations clarify that taxpayers can make specific identifications in advance of securities sales (including fund share redemptions). For example, a shareholder should be permitted to instruct the broker, when the fund account is opened, always to sell first the shares with the highest cost basis. [16]

b. HIFO as a Permissible Broker Default Method

The Institute recommends that IRS regulations expressly provide that the highest-in first-out ("HIFO") method (or any other similar method of specific identification) is a permissible broker default method. As discussed above, specific identification of shares must be made contemporaneously with a sale of securities.[17] HIFO is a form of specific identification, but it also is a formulaic method that can be adopted in advance. Any requirement that a shareholder specifically state, at the time of *each* redemption, that the HIFO method is being elected would complicate unnecessarily the redemption process. Shareholders would receive no benefit from this complexity; they always would retain the ability, at each redemption, to override a HIFO or similar formulaic default method.

c. Confirmation of Specific Identification

The Institute submits that the current rule requiring broker confirmation of shares specifically identified is unnecessary for shares subject to the new basis reporting requirements. For shares acquired after the Legislation's effective date and subsequently sold, the Form 1099 effectively will provide confirmation by the broker that the specific identification requirements (including contemporaneous identification by the customer) were met.

d. Time for Electing FIFO or Average Cost

Any tax policy rationale compelling contemporaneous determinations for specific identification would seem absent in the case of FIFO and average cost elections. Moreover, present law does not require that a decision to use either of these methods be made contemporaneously with the redemption. Instead, each of these methods effectively can be chosen on an investor's tax return.

Considerable administrative complexity would arise, however, if fund shareholders could choose either FIFO or average cost as basis methodologies up to the date that cost basis information is reported by the broker. These complexities would include substantial communications efforts and

[16] In Rev. Rul. 61097, 1961-1CB 394, the IRS ruled that shareholders may direct their brokers to use a systematic plan of liquidation, even if conducted over a long period of time. For purposes of Treas. Reg. § 1.1012-1(c), an adequate identification is made if the owner (1) specifies to the broker in writing the sequence in which he desires the shares to be sold, (2) identifies the shares to be sold either by their purchase date, cost, or both, and (3) receives a written confirmation of the specification from the agent.

[17] Treas. Reg. § 1.1012-1(c)(1).

manual inputs or overrides of previously made calculations. The longer the period permitted, after a redemption, to make a decision, the greater the likelihood that an account will have been transferred from one broker to another; regardless of which broker received the customer's methodology decision, the decision would need to be communicated to both brokers, as the cost basis of the shares sold would determine, in part, the cost basis of the remaining post-transfer shares.

Requiring contemporaneous decisions to override a default method, in contrast, would create other difficulties. Because investors have so many different ways to redeem RIC shares, in many instances there will be no contemporaneous opportunity to communicate with the shareholder regarding cost basis methodologies.[18] For example, when a redemption occurs through a check written on a mutual fund account, through a systematic withdrawal, or through a redemption order mailed to the fund, no opportunity exists to ask the customer at that point to choose a basis method.

Nevertheless, if the shareholder is required to use the basis information provided by a broker, the most efficient and practical rule would be to require a shareholder to make his or her basis method election before or at the time of redemption. If the IRS believes, however, that some post-redemption opportunity should be provided to elect FIFO or average cost, we recommend that such ability be limited to a short duration (*e.g.*, 10 business days).

e. Corrections

The regulations must permit brokers to correct mistakes made in calculating cost basis, whether those mistakes arise from mathematical error or from the broker's failure to follow a customer's instructions regarding the cost basis method to be used. Moreover, there should be no time limit (other than any new generally applicable limit on amending information returns and statements) on a broker's ability to correct these mistakes. In some cases, a broker will not be advised of the mistake until the shareholder prepares his or her tax return. These rules are critical if fund shareholders will be required to use the cost basis information provided by the broker.

f. Flagging Inaccurate Data

A shareholder must have the ability to indicate, perhaps on Schedule D to Form 1040, that the cost basis data provided by a broker (that the shareholder otherwise is required to use) is inaccurate or otherwise does not match that used by the shareholder. The difference might involve either an understatement of tax liability (*e.g.*, the broker was not aware of a taxpayer's wash sale effected through different accounts) or an overstatement of tax liability (*e.g.*, the broker failed to follow the taxpayer's instructions to use HIFO).

[18] In some cases, such as requesting a transaction through a broker or placing a telephone call directly to a fund customer service representative, the opportunity to prompt the shareholder to elect a cost basis method will be available.

The IRS should provide space on the Schedule D for the taxpayer to indicate why the broker's number does not match that used by the shareholder. This additional information would reduce the IRS' need to follow up with the taxpayer for differences. At a minimum, the form should provide an indicator (or "flag") that would alert the IRS to the fact that the taxpayer is aware that the tax return number and the broker-provided number will not match.[19]

g. Wash Sales

Regulations will need to clarify the interaction between the cost basis reporting rules of section 6045 and the wash sale rules of section 1091. Specifically, section 6045(g)(2)(B)(ii) provides that a customer's cost basis, for section 6045 reporting purposes, includes the effect of the wash sale rule only if the wash sale occurs in the same account. Presumably, however, the shareholder still has an obligation to apply the wash sale rule. The regulations under section 1012 must provide that taxpayers cannot rely upon cost basis provided under section 6045 if the number does not reflect wash sales, or they will be able to manipulate the rule with ease. A taxpayer could do so by selling a loss security in an account held through one broker and buying the same security in an account held through a different broker. It is extremely difficult to believe that Congress intended this result.

2. Guidance if Use of Broker-Provided Numbers is Not Required

Significantly less guidance is needed if shareholders are not required to use broker-provided cost basis information. Some guidance will be necessary, based upon the fund industry's experience, because most shareholders can be expected to use information provided (even if not required to do so).

We suggest that IRS provide shareholders with the ability to explain on Schedule D how cost basis was calculated if they choose not to use broker-provided cost basis information. This information might reduce any concern that cost basis was calculated incorrectly.

Similarly, if a shareholder notifies a broker that he or she is using a method different from that being provided on the Form 1099, the broker should have the discretion (but not the requirement) to take information provided by the shareholder. In such cases, as discussed below, the broker should not be subject to penalties for the inaccuracy of the shareholder-provided basis information.

Finally, if the broker learns that the shareholder is not using the data provided or chooses not to take shareholder-provided information, the shares in that account no longer should be treated as "covered securities" subject to the basis reporting requirements. In these situations, continued reporting under section 6045(g) no longer would be required.

[19] In such cases, brokers should be permitted to use shareholder-provided data, as discussed below.

C. *Effective Date for Fund Shares*

The IRS should clarify that the January 1, 2012 effective date applies to shares of exchange-traded funds and closed-end funds, as well as to mutual fund shares. Although the Institute believes the Legislation is clear, at least one commentator has expressed confusion on this point. Section 6045(g)(2)(B)(i)(II) provides this later effective date "in the case of any stock for which an average basis method is permissible under section 1012." Under these regulations, any RIC that meets the requirements of Treas. Reg. section 1.1012-1(e)(5) qualifies for the average cost method. These regulatory requirements – that the RIC qualify under Code section 851(b) and be registered under the Investment Company Act of 1940 as a management company or a diversified unit investment trust – are met by exchange-traded funds and closed-end funds. Moreover, the enacted statute was modified during the legislative process specifically to address the effective date for exchange-traded funds and closed-end funds.[20]

D. *Definition of "Account"*

Regulations should clarify when securities, including fund shares, are held in the same "account."[21] Funds today consider an "account" to mean a shareholder's position, or holdings, in a single fund.[22] A single fund is defined at the Committee on Uniform Security Identification Procedures ("CUSIP") number or share class level.[23] Each account is identified with a discrete taxpayer. A shareholder's position in a fund, held in his or her own name, for example, is treated as in an account separate from a position in the same fund held by such shareholder jointly with a spouse. These positions are segregated in different accounts because, among other reasons, of the different legal rights that the shareholder has in each position. All of a fund's record keeping and information reporting systems are based on this definition of "account." Therefore, this same definition should apply for purposes of basis calculation under section 1012.

E. *Dividend Reinvestment Plans*

The Institute does not have any specific recommendations for guidance under section 1012(d), which provides that in the case of stock acquired in connection with a dividend reinvestment plan (a

[20] Earlier bills applied the later effective date to "open-end funds." After discussions between the Institute and Congressional staff, the statutory language was changed to cover these funds.

[21] Under section 1012(c)(1), as amended by the Legislation, the basis calculation conventions made under the section 1012 regulations apply to shares acquired after the applicable effective date on an "account by account basis."

[22] This definition of "account" differs from the typical broker-dealer "account," which may include all of the shareholder's holdings with that broker-dealer.

[23] For example, funds currently treat Class A shares and Class B shares in the same fund as separate accounts. Consequently, they currently calculate average cost basis separately for each share class.

"DRIP"), the average cost method may be used to determine the basis of such stock while it is held in such plan. We understand that this provision was added to the statute to facilitate cost basis reporting for corporate DRIPs. Fund shareholders participating in DRIPs in their funds already are able to use the average cost method. Our only comment on this section is that, as it was not intended to affect mutual fund DRIPs, any issued guidance thereunder expressly should exclude (or not impact negatively) DRIPs offered by funds.

III. Basis Calculation Issues

A. *Basis Adjustments*

Guidance will be needed to address certain cost basis adjustment rules to the extent that they cannot be applied until after December 31 of the year in which the redemption occurred. These rules could require funds to send amended Forms 1099 to shareholders months, even years, after the original Forms 1099 are sent. Without administrative relief, that is consistent with the underlying purposes for the rules, significant unnecessary burdens will be imposed on shareholders, funds, brokers, and the IRS.

We recommend, in particular, regulatory guidance to eliminate unnecessary amended Forms 1099 resulting from returns of capital and sales load basis deferrals. While the extension of the deadline, from January 31 to February 15, for sending tax information to shareholders will reduce substantially the difficulties caused by the wash sale rule, additional relief for *de minimis* corrections would be helpful as well.

1. Returns of Capital

The Institute recommends that the section 316 regulations be modified to require a fund to allocate a return of capital ratably over distributions made during the portion of the fund's taxable year that arises during the calendar year in which the taxable year ends. This substantive law change would address a difficulty, relatively unique to funds, that can force amended Forms 1099 to be sent many months into the next calendar year (and often after shareholder tax returns have been filed).

The need for relief arises from fund-specific requirements that essentially force funds to distribute their income currently. Under one such rule, funds effectively are required to distribute by December 31 of each calendar year essentially all of their calendar-year income.[24] In addition, funds

[24] Specifically, section 4982 imposes an excise tax on a fund that does not distribute by December 31 an amount equal to the sum of (i) 98 percent of its ordinary income for the calendar year, (ii) 98 percent of its capital gain net income for the 12-month period ending on October 31, and (iii) any amount not distributed for the prior calendar year. An excise tax of 4 percent is imposed upon the excess of the "required distribution" (as calculated above) over the amount actually distributed.

typically distribute all of their income for each taxable year (which typically is not the calendar year) to eliminate any fund-level tax on their income.[25]

These fund-specific distribution requirements, together with transactions generating ordinary losses (such as currency losses realized upon the disposition of a foreign security or losses from certain derivative investments), can cause funds inadvertently to overdistribute their income, *i.e.*, to distribute more than their taxable income and gains for the year. These losses can be particularly problematic when they occur after funds have made distributions to meet their calendar year distribution requirements and have little time, before their taxable year ends, to generate enough income to offset the losses.

Under Treas. Reg. § 1.316-2(b), a return of capital must be allocated pro rata over all distributions made during the taxable year, including distributions that were made during the portion of the taxable year that occurred in the calendar year prior to the calendar year in which the taxable year ends (*i.e.*, to the "pre-January portion" of the taxable year). This allocation has two effects. First, some portion of any distribution made during the pre-January portion of the taxable year, and reported on Form 1099 as taxable income or gain, retroactively becomes a non-taxable return of capital. Second, the cost basis of each share held on the date a return of capital distribution was made must be reduced by that share's allocable portion of the return of capital; if those shares then were sold in the prior calendar year, the amount of the taxable gain or loss also would change (because of the retroactive basis reduction).

> *Example.* Assume a fund with a taxable year ending October 31 that makes monthly distributions. Further assume that the fund begins operations on November 1 of Year 1 and distributes $1,000 per month to its shareholders. Further assume that in October of Year 2 the fund incurs substantial foreign currency losses that reduce its earnings from $12,000 ($1,000 per month) to $6,000. Because 50 percent of the fund's distributions no longer are supported by earnings and profits for the taxable year, 50 percent of each monthly distribution retroactively becomes a return of capital, including the distributions in November and December of Year 1.

The return of capital allocation rule retroactively can impact dividend distributions and shareholder-level capital gains or losses that arose in a prior calendar year and that, in many cases, already have been reported on tax returns filed by fund shareholders. Substantial confusion can arise if shareholders receive amended Form 1099s and cost basis statements and are told to amend their individual income tax returns. This confusion is particularly acute if the amended Forms 1099 arrive after tax returns have been filed and the required changes are small.

[25] Because of these distribution requirements, funds rarely have accumulated earnings and profits from prior years.

The Institute recommends, because of the unique return of capital issues affecting funds and fund shareholders, that the IRS amend the regulations under section 316 to provide that earnings and profits are allocated first to distributions made during the pre-January portion of the fund's taxable year.[26] The result would be that returns of capital would be allocated first to the portion of a fund's taxable year that begins on January 1 of the calendar year in which the fund's taxable year ends. Thus, in the example above, the $6,000 return of capital would be allocated pro rata ($600 per month) to the 10 distributions made between January and October of Year 2 and no amended Forms 1099 or amended shareholder tax returns would be needed. Making this change would greatly reduce the number of amended Forms 1099 that funds will have to send to shareholders reflecting adjustments to their cost basis.

2. Sales Load Basis Deferral Rules

The Institute recommends a change, only for purposes of a broker's reporting obligations under section 6045, to the sales load basis deferral rule of section 852(f). This provision was enacted in 1989 to prevent investors in funds from engaging in a transaction that effectively allowed them to deduct, rather than capitalize, the commission paid to purchase shares. When applied in the context of cost basis reporting, however, it could force brokers to send amended cost basis statements many months or years after a redemption occurs.

The specific transaction at issue involved an investor who wanted to acquire shares of a particular fund ("Fund B"); if the Fund B shares were purchased directly, the sales charge associated with the purchase would be capitalized into the cost basis of the Fund B shares. Rather than purchase Fund B shares, however, the investor would (1) purchase shares of another fund ("Fund A") offered by the same adviser, (2) redeem the Fund A shares (generally the next day), and (3) exercise what section 852(f) refers to as a "reinvestment right" arising from the Fund A share purchase to acquire shares of Fund B and have the sales charge on the new shares reduced or waived. The sales charge paid on the Fund A shares would generate a short-term capital loss that would offset unrelated capital gains.

Under section 852(f), the front-end sales charge on the Fund A shares is not taken into account in computing gain or loss on the Fund A shares, but is instead treated as incurred in the acquisition of the Fund B shares, if the shareholder (1) disposes of Fund A shares within *90 days* after they are acquired and (2) *on any date thereafter* acquires the Fund B shares pursuant to the reinvestment right.

The rules in section 852(f) are much broader and more complex than is necessary. For example, the rules apply even if the investor redeems the Fund A shares and invests in a money market fund (for which no sales charge is imposed) and several years thereafter redeems the money market fund shares and invests in Fund B without incurring an additional sales charge. While this transaction clearly is not

[26] The Institute also is seeking a legislative solution to this problem.

the type for which the rules were crafted, section 852(f) nevertheless requires a retroactive recalculation of the gain or loss on the Fund A shares.

The cost basis reporting requirements make the open-ended nature of the sales load basis deferral rule much more problematic and will create significant administrative burdens. Application of the sales load basis deferral rule could require brokers to send amended cost basis reports months or years after the original reports were sent and shareholder tax returns were filed.[27] Shareholders, in turn, would be required to amend their individual income tax returns to remove the sales charge from the cost basis of the redeemed shares; the IRS would be required to process these amended cost basis statements and individual tax returns.

The Institute recommends that the IRS issue guidance stating that, for cost basis reporting purposes, brokers need not apply the sales load basis deferral rule, provided that the shareholder does not exercise the reinvestment right by January 31 of the calendar year following the calendar year in which the shareholder disposed of the first-acquired shares (*e.g.,* Fund A in the example above).[28] This guidance would apply only for information reporting purposes; the rule still would apply to shareholders. Limiting the application of section 852(f) in this manner would continue to prevent the abuse for which the rule was crafted without creating the new recordkeeping burden that otherwise will arise from cost basis reporting.

3. Wash Sales

The Institute suggests a modest *de minimis* exception to the wash sale rule of section 1091. Our recommendation would reduce the possibility of amended Forms 1099 being sent to adjust a small reported loss on a redemption occurring in December that is disallowed, in whole or in part, because of a share purchase in January that occurs within 30 days of the redemption.

The Legislation reflects one concern with the wash sale rule. Specifically, section 6045(g)(B)(ii) provides that, for purposes of cost basis reporting, a customer's adjusted basis shall be determined without regard to the wash sales rules of section 1091 unless the transactions occur in the same account with respect to identical securities.[29] The Congress added this exception to the cost basis reporting requirement because it recognized the operational and practical problems created if a broker were required to monitor its customers' activities across accounts for wash sales.

[27] It will be even more difficult to apply this rule if the account subsequently has been transferred, such that the responsibility to amend Forms 1099 and adjust cost basis records lies with a former broker.

[28] The Institute also is seeking a legislative solution to this issue.

[29] The Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 110th Congress (the "JCT Bluebook") notes that, for purposes of cost basis reporting, "identical securities" are to be determined by the CUSIP number of a security. JCS-1-09, p. 365. The Institute agrees that this should be the rule.

Currently, most funds monitor their shareholder's accounts for wash sales by performing "wash sale runs" on a monthly basis. This is an automated process. Therefore, making adjustments to a customer's basis as a result of a wash sale should not be problematic as a general matter.

The extension of the reporting deadline from January 31 to February 15 will make it easier for funds to apply the wash sale rule to December redemptions followed by January purchases without amending Forms 1099. Nevertheless, to the extent that cost basis statements are prepared before a "wash sale run" is performed (*e.g.*, the fund is performing calculations for intermediaries who need the information sooner to include it with other information compiled for a customer), amended 1099s still may be required.

The Institute recommends that funds have the option not to apply the wash sale rule to correct Forms 1099 for *de minimis* losses of $10 or less arising from share purchases occurring after December 31 that affect the cost basis of shares sold before January 1 (and within 30 days of the purchase). Particularly where the impact of the wash sale is *de minimis*, the benefit to the government of Forms 1099 being corrected appears to be outweighed by the burden.

B. *Average Cost Basis*

1. Use of Average Cost When Shareholder has Multiple Accounts in Fund

The Institute recommends that IRS regulations expressly permit shareholders to use different cost basis methodologies for different accounts in the same fund, whether those accounts are with one or multiple brokers. The Legislation amended section 1012 to provide that the conventions prescribed by regulations under section 1012 shall be applied on an account-by-account basis, indicating that a shareholder can use different basis methods for different accounts for shares acquired after the effective date.[30] The current section 1012 regulations provide, in effect, that a shareholder who elects to use average cost for shares in a fund must use that method for all of the shareholder's accounts in that fund.[31] These regulations should be amended to conform with the statutory changes to section 1012.

The purpose for the existing regulatory requirement is unclear. The regulatory authority to calculate cost basis under the average cost method was requested by a fund company almost 40 years ago when data storage was particularly expensive; this method was urged because it permitted the company to consolidate the lot histories (including cost basis) of all shares held for the long-term holding period. Average cost, in effect, is a method of convenience.

It is not clear, from a tax policy perspective, why a shareholder could not elect the convenience provided by average cost for one account in a fund (such as one in which shares are purchased weekly)

[30] Section 1012(c)(1).

[31] Treas. Reg. § 1.1012-1((e)(2).

but not another (for which the recordkeeping on a lot-by-lot basis would be far simpler). Using different cost basis methodologies for different accounts in the same fund do not present any tax planning opportunity that is not available merely by specifically identifying the lots being sold.

The rule's effect also is hard to understand when applied to a shareholder with partial interests in multiple accounts in a fund. If one account is with the shareholder's son and the other is with the shareholder's daughter, an election to use average cost for one account seems to *require* its use in the other account. There is no clear rationale for requiring the daughter to use average cost only because her brother also has a joint account with their parent and has elected the convenience of average cost.

Given the addition of section 1012(c), together with the lack of a compelling tax policy rationale for requiring the use of average cost for all accounts in a fund and the difficulty of enforcing the regulatory requirement, we urge that the requirement be eliminated.

2. Treatment of Old and New Shares

Eliminating the regulatory requirement to use average cost for all accounts in a fund if it is used for any account in the fund would conform the regulations to another aspect of the Legislation. Specifically, the Legislation treats shares acquired before January 1, 2012, as in a separate account from any shares acquired after December 31, 2011.[32] The current regulation, as applied to section 6045(g), seems to require any shareholder who elected average cost for shares in a pre-effective date account also to use average cost for shares in the same fund in a post-effective date account. Because cost basis reporting is not required for the old shares, the shareholder would have two different average cost bases: one for the old shares (not subject to reporting) and one for the new shares (subject to reporting).

Average cost basis, in effect, is a broker default method of calculating cost basis that was provided voluntarily. By treating old shares as in an account separate from new shares in the same fund, the Legislation effectively provides a "clean slate" for cost basis reporting. Based on our conversations with Congressional staff, we understand this to be Congress' intent.

3. Election to Combine Old and New Shares

The Institute suggests one modest clarification to encourage brokers to combine pre-effective date and post-effective date fund shares in a single account. Specifically, we suggest that regulations provide appropriate penalty relief for the cost basis of pre-effective date shares.

We suggest this change because the Legislation, as noted above, treats shares in a fund acquired before the effective date as in one account and shares in that fund acquired thereafter as in a different account. Section 6045(c)(2)(B) provides that a fund may elect, with respect to one or more

[32] Section 6045(c)(2)(A).

shareholders, to combine the pre- and post-effective date shares into a single account for information reporting purposes.

Funds that voluntarily provide cost basis information to their shareholders may continue to do so for pre-effective date shares. In general, however, we do not expect them to provide this information to the IRS because, among other things, of concerns discussed above about the precise accuracy of some of the information provided today.[33]

Going forward, some funds may choose to make the single-account election for certain shareholders. Shareholders might request that funds make this election, for example, if they already are using the average cost basis information provided voluntarily by the funds and prefer the convenience of receiving only one cost basis statement for all shares (both old and new) in that fund.

Nevertheless, funds might be disinclined to make the election unless they were highly confident in the accuracy of the cost basis information for pre-effective date shares. Even then, funds might be reluctant unless there is appropriate penalty relief for pre-effective date basis information. The Institute's proposal, which would enhance tax compliance, might encourage funds to make the election to combine pre- and post-effective date shares in a single account.

4. Double-Category Method

We recommend that the IRS and Treasury amend Treas. Reg. § 1.1012-1(e) to eliminate the double-category method of computing average cost for RIC shares acquired after January 1, 2012. We understand that the industry calculates cost basis only under the single-category method. Because the double-category method is more complicated to apply, we believe it is unlikely that shareholders are using that method on their own.

If the double-category method is not eliminated, brokers will be required to incur the substantial cost of developing cost basis calculation programming for this method. We do not believe that there are any benefits to justify this cost since (1) we are not aware that a single taxpayer has used this method in the 38 years since it was made available and (2) the method provides no discernable benefit over single-category average cost.

[33] State privacy laws may prevent RICs from reporting information to the IRS that is not otherwise required under the law. In such cases, the government would be treated as a "third party," and the shareholder's consent would be needed to provide that information.

5. Electing Out of Average Cost

The Institute urges the IRS to eliminate the current regulatory requirement that a shareholder who has elected average cost receive the Commissioner's consent before revoking that election.[34] This rule should apply both to shareholders who have not yet redeemed shares, and those who have redeemed shares and elected to use average cost. We see no reason to maintain the current requirement because, as noted above and below, the rule requiring a shareholder to use average cost for all shares in a fund (regardless of the number of accounts in that fund) does not appear to have any tax policy rationale. The amendment to section 1012 that requires basis calculations to be determined on an account-by-account basis suggests that a shareholder effectively could revoke an average cost election for future share purchases by opening another account with the broker. Permitting shareholders to revoke an average cost election without IRS consent would avoid this added complexity.

If a shareholder selects average cost as his or her basis method, the shareholder should be permitted to change that election prior to a redemption. The existing regulatory requirement was crafted at a time when average cost was elected with the filing of a tax return. Because the Legislation effectively may force shareholders to select a cost basis methodology when the account is opened (or at some time prior to a redemption), they should be permitted to revoke that election if no shares have been redeemed and, under prior law, the election would not yet have been made.

If shareholders are permitted to revoke their average cost elections after a redemption has occurred in the account, guidance will be necessary to determine the cost basis of remaining shares. The most reasonable approach would be to require that all shares to which the election applied have the same basis, equal to the average cost for the account, going forward. This is the only workable result if shares previously had been redeemed by the shareholder; in such a case, there would be no way to determine which shares remained, even if the entire purchase history still were available.

C. *Default Rules for Re-Registered Shares*

The Institute believes that brokers should be permitted voluntarily to include in cost basis reported to the IRS shares that are not covered securities because title to the shares has been re-registered. Default rules, with appropriate penalty relief, should be provided for determining the cost basis of these shares.

Section 6045(g) does not apply to shares that are re-registered within an individual fund (*i.e.*, when the name and tax identification number associated with the shares are changed).[35] Share re-

[34] Treas. Reg. § 1.1012-1(e)(2). A change to this rule, however, should not permit a shareholder to revoke an average cost election for a redemption that has occurred in the current taxable year.

[35] Section 6045(g)(3)(A) defines a "covered security" as a security acquired on or after the effective date if such security (i) was acquired through a transaction in the account in which such security is held, or (ii) was transferred to such account from

registrations may occur when shares are: (1) transferred to or from accounts with multiple owners; (2) inherited from another person; (3) gifted from another person; or (4) transferred for value. Share re-registrations present knowledge issues (*e.g.*, the reason that the shares are transferred) and property right issues (*e.g.*, the transferor's and transferee's rights, under state law, in the shares, which can affect the basis adjustments). In many cases, the broker will not know either the reason for the transfer or the relevant state law considerations.[36] Because of the complexities involved with re-registered shares, Congress excluded them from the basis reporting requirements.

To facilitate voluntary reporting of re-registered shares to the IRS and shareholders, the Institute recommends that the IRS provide the following default rules. Unless the broker has actual knowledge that shares have been inherited, the broker should be permitted to apply a default rule that treats as the cost basis of the re-registered shares the carry-over cost basis of the shares.[37] If the broker knows that the shares have been inherited (*e.g.*, because the broker received a death certificate) and chooses to provide cost basis information for them, the default rule should be a full stepped-up basis on the date of death, in the case of a single account owner, and a proportionate stepped-up basis, in the case of joint account owners. In all cases, the broker should be allowed to override the default rule if it receives basis information from the shareholder (with appropriate penalty relief for using shareholder-provided information, as discussed below).

D. *Customer-Provided Information*

Regulations should permit brokers to take and use basis information provided by a customer in certain situations. For example, if there has been a re-registration and the broker uses a default basis (as should be permitted under regulations), the shareholder should be allowed to provide the broker with the correct basis information. Also, if a shareholder is not required to use the basis information provided by a broker, a broker should be permitted to take shareholder information (at the broker's

an account in which such security was also a covered security, but only if the broker received a transfer reporting statement, as required under section 6045A. The JCT Bluebook notes that, under this rule, certain securities acquired by gift or inheritance are not covered securities. JCS -1-09, p. 363.

[36] Today, the fund industry generally does not transfer the cost basis from the original account to the new re-registered account because the fund has no independent knowledge of the cost basis of the new shares. The correct cost basis for the re-registered shares could be a carryover basis (for gifted shares), a partial or full fair market value stepped-up basis (for inherited shares), or a basis calculated by reference to other factors (*e.g.*, a transfer for value). Issues involving transfers are particularly difficult when shares are transferred to or from accounts with multiple owners. The relevant cost basis can turn on factors such as whether one or more joint account owners purchased shares in the account and the relevant contributions to the account by the joint owners.

[37] The Treasury regulations contain a provision that prohibits a donee from using the average cost method if the carry-over basis of the gifted shares is less than the fair market value of the shares at the time of the gift. Treas. Reg. § 1.1012-1(e)(1)(ii). This regulation should be modified to permit RICs to use a carry-over basis for Form 1099 reporting in these situations.

discretion) if the shareholder uses a basis method on his or her tax return that is different from that used by the broker. Brokers also should be permitted, as discussed above, to take customer-provided information to fix inaccurate basis information (*e.g.,* the shareholder informs the broker that a wash sale has occurred).[38]

Allowing brokers to use shareholder-provided information in such situations would make it more likely that brokers would voluntarily provide to the IRS basis information for non-covered securities. Further, it would help ensure that basis information for covered securities is accurate, and that the shareholder's information and the broker's information continue to match going forward. Brokers should not be liable, however, for the inaccuracy of such shareholder-provided information, and brokers should not be required to review the accuracy of such information (for the reasons discussed below).

IV. Transfers

A. *Defining "Brokers" and Required Information*

The Institute recommends that the current rules defining a "broker" for information reporting purposes also should apply for transfer reporting statement purposes. We also make several recommendations regarding the information that should be provided by a transferor to a transferee so that the transferee broker can track and report cost basis.

Section 6045A requires that an "applicable person," who transfers covered securities to a broker (as defined in section 6045), furnish a written statement setting forth information permitting such broker to comply with the cost basis reporting requirement. An "applicable person" means (1) any broker (as defined in section 6045(c)(1)), and (2) any other person as provided in regulations.[39] For information reporting purposes, section 6045(c) defines a "broker" as including (A) a dealer, (B) a barter exchange, and (C) any other person who (for a consideration) regularly acts as a "middleman" with respect to property or services.[40]

The Institute recommends that the current rules defining a "broker" for information reporting purposes also should apply for transfer reporting statement purposes. In the case of mutual funds, this definition of "broker" includes fund transfer agents and intermediaries that are responsible for

[38] As discussed above, shareholders should have the ability to indicate on the Schedule D that the basis information provided by the broker is inaccurate.

[39] Section 6045A(b).

[40] Treas. Reg. § 1.6045-1(a)(1) defines a broker as any person that stands ready to effect sales to be made by others. The examples in Treas. Reg. § 1.6045-1(b) illustrate generally who is (including a mutual fund or an agent of the mutual fund who stands ready to redeem or repurchase shares in the fund) and who is not a broker for these purposes.

transmitting proceeds to investors who have redeemed shares; these agents and intermediaries are required to report gross proceeds under the current Form 1099 reporting rules. This definition also includes designated agents (third party transfer agents or service providers) contracted by funds or broker-dealers to assist with trading, recordkeeping, cost basis and transfer reporting responsibilities.[41] We are unaware of any parties not currently responsible for information reporting under 6045(c) that should be responsible for transfer reporting statements under section 6045A.

We have several recommendations regarding the information that should be provided by a transferor to a transferee so that the transferee broker can track and report cost basis. The transfer statement should include basic information regarding the transferor and customer (*e.g.*, name and tax identification number of both transferor and customer), in addition to lot detail that would allow the broker to satisfy the basis and holding period reporting requirements of section 6045(g). For all shares for which cost basis reporting is required, this information should include, at a minimum: (1) date of purchase for each lot;[42] (2) CUSIP numbers; (3) number of shares; (4) adjusted cost basis at the time of transfer; and (5) whether average cost has been reported for shares redeemed in the account.[43] In addition, if cost basis is provided voluntarily for non-covered shares, the information provided should identify the shares and the basis upon which cost basis was calculated (including application of a default method for gifted/inherited shares, the use of pre-effective date basis, and the extent to which information is customer-provided).

B. *Transfer Methods*

The Institute recommends that the IRS clarify promptly that section 6045A's requirement that a transferring broker submit a "written statement" to the receiving broker may be satisfied by electronic submission. The JCT Bluebook states that Congress contemplated that electronic submissions would be permitted.[44] Significant inefficiencies and unnecessary costs would be introduced if the IRS were to require that these information transfers be made on paper.[45]

[41] Agreements are executed between such parties for services provided to ensure performance of duties and provide indemnifications and recourse for parties to these agreements where appropriate.

[42] For accounts for which average cost has been selected, it may be possible to report only that the shares have a long-term holding period.

[43] As discussed above, a question that should be clarified is whether a shareholder may switch from average cost to another method if he or she transfers shares to another broker.

[44] JCS-1-09 p. 367.

[45] Nevertheless, other forms of information transfer, including paper documents that are mailed, faxed, or hand delivered, must be permitted. Many fund transactions still occur through these forms of communication, particularly when smaller intermediaries and financial advisers are involved. The costs of requiring all broker data transfers to be made electronically also would introduce unnecessary, and substantial, costs.

The majority of fund shareholder transactions, as noted above, are transmitted electronically today through systems such as Fund/SERV and Networking. Most account transfers between brokerage firms that involve fund shares are transmitted electronically through another system developed by NSCC: the Automated Customer Account Transfer Service ("ACATS") system.[46] Most industry NSCC participants will utilize these systems, or other forms of electronic transmission, to transfer cost basis information. Not only are these systems fast and reliable, but they provide an efficient mechanism for supplementing submissions and correcting errors.

We urge the IRS, however, not to prescribe specific data formats, other than basis information that must be transferred. The fund industry and the financial intermediaries are in the best position to decide upon appropriate formats for transferring this information. Indeed, Institute committees of fund and financial intermediary representatives have a long history of working productively together, alone and with representatives of DTCC, to improve operational efficiencies in the servicing of shareholder accounts.

Consistent with our well-established working relationship, an Institute task force of funds, brokerage firms, service providers, and the NSCC already has begun to define transfer reporting requirements for fund shares and recommend system changes that would allow cost basis information to move between funds and intermediaries (securities brokers, banks, and others) that are NSCC participants.[47] Many significant scenarios require detailed analysis so that appropriate systems requirements are established to transfer the required information between brokers. These scenarios include situations in which non-covered securities (*e.g.*, pre-effective date shares, customer-supplied information, etc.) are transferred, partial transfers, and post-transfer basis adjustments, among other things. Once these specifications are fully vetted, systems development work, implementation, and testing will follow.

C. *Partial Transfers*

The Institute requests guidance prescribing the cost basis of shares transferred when a shareholder transfers only some shares in a fund from one broker to another. In this case, we suggest that the default rule for partial transfers be the same as the cost basis method elected for the account by the shareholder (or the broker's default method, if no other method has been selected). Thus, for example, if the shareholder has selected FIFO, the shares transferred would be those acquired first. The

[46] ACATS is a system that automates and standardizes procedures for the transfer of assets in a customer account from one brokerage firm and/or bank to another. Instruments handled by the system include equities, corporate and municipal bonds, unit investment trusts, mutual funds, options, cash and other investment products.

[47] Today, cost basis information does not move between funds and intermediaries when fund shares are transferred between intermediaries. The voluntary cost basis reporting system (the Cost Basis Reporting Service, or "CBRS") developed several years ago by NSCC has not been utilized by funds because they are not ACATS participants.

shareholder would be permitted, as with cost basis reporting, to override the default method by identifying the shares transferred along with the partial transfer instructions.

D. *Reporting Timeframes*

The Institute submits that no regulatory guidance is needed under Section 6045A regarding the 15-day time limit, following an account transfer, for the transferring broker to provide the transferee broker with cost basis information. The 15-day period provided by Congress represented a compromise between an initial version of the cost basis reporting legislation, which provided a 45-day transfer period, and an interim version of the legislation, which required that all cost basis information be transferred on a same-day basis. Among other things, the 15-day reporting period allows for error corrections and manual transfers.

While it undoubtedly is preferable for all account information to transfer at once, it will not be possible for all industry participants to meet a "same-day" transfer requirement. Nevertheless, because of the efficiencies of automated transfers, industry participants will endeavor to transfer cost basis information with other transferred shareholder records. Many industry participants will be able to send transfer records electronically at or immediately following the transfer of shares either as soon as the Legislation is effective or shortly thereafter; most others hopefully will be able to make contemporaneous transfers within a few years after the Legislation becomes effective.

Any IRS consideration of shortening the 15-day period provided by Congress should take place many years from now, after the industry has had time to absorb the tremendous burden created by the Legislation. The amount of work necessary to develop systems to seamlessly transfer the huge volumes of data required by the Legislation cannot be underestimated. The task is monumental. The industry currently is operating under the assumption that the IRS will not upset the compromise reached by the Congress. Were a decision announced, shortly before the Legislation becomes effective, to shorten the transfer period, the disruption to industry planning would be extensive.

E. *Transmitting Data – Duties and Responsibilities*

The Institute believes that the obligation to provide the transfer reporting statement to the transferee on a timely basis should remain entirely on the transferring broker. The receiving broker should not be required, subject to penalties for non-compliance, to contact the transferring broker to determine whether or not a transfer reporting statement should have been sent. Reasonable follow-up procedures (not involving IRS penalties) for failures to receive transfer reporting statements for both automated and manual transfers will be developed by the industry.

We do recommend, however, that an indicator be placed on the Form 1099 so that the IRS and shareholders are informed that any subsequent reporting by the transferee broker includes only the transferee's data. Transferees must be able to indicate that the Form 1099 includes non-covered shares, for which no basis information is required, and thus the transferee brokers are not accountable for missing basis information on those shares.

We also recommend that brokers not be required to verify the accuracy of basis information received from another party. No system exists for checking the accuracy of such information; the costs of building one would be substantial. Moreover, the procedures to attempt to verify basis information received from another party would be extraordinarily difficult to implement efficiently. What is envisioned as an electronic transfer would become burdened with either an automated check, that would be difficult (at best) to create, or a manual review process that would be unworkable.

F. *Post-Transfer Changes to Cost Basis*

Because brokers are required to report cost basis information accurately, they will make appropriate adjustments to the cost basis of their customers' shares. Lot information transferred for basis reporting will include both short-term and long-term position detail. Detailed data (including purchase date and number of shares acquired) will be provided for short-term lots so that transferee brokers can make corporate action adjustments (such as returns of capital) to shares transferred. Broker basis reporting systems will need modifications to enable such adjustments. Brokers transferring accounts will be responsible for making corporate action adjustments subsequent to a transfer that affect the basis calculation for shares redeemed prior to the transfer, for which the transferor broker retains Form1099 reporting responsibilities.

G. *Transfer of Voluntary Basis Information*

No guidance is necessary regarding any voluntary transfers of basis information on pre-effective date shares or with respect to mutual fund securities that are not "covered securities." Each industry participant will decide independently whether to provide shareholders with cost basis information for these shares and, if so, whether also to provide cost basis information based upon data regarding these non-covered securities received from transferors, such as brokers or other third party providers, or shareholders.

V. Reporting Cost Basis Information

A. *Parties Responsible for Cost Basis Reporting*

The Institute recommends, as a general matter, that the gross proceeds rules that apply currently under section 6045 apply as well for cost basis reporting under section 6045(g). Detailed rules already are provided by the Code and Treasury regulations for information reporting by brokers. The Legislation simply increases the amount of information that must be reported to shareholders under section 6045.

The definition of broker provided by section 6045(c), we submit, encompasses all parties that would have any responsibility for cost basis reporting. Any party currently treated as a "middleman" for gross proceeds reporting will be treated, we believe appropriately, as a middleman for cost basis reporting purposes.

Likewise, the current regulatory provision designed to prevent duplicate information reporting by multiple brokers will prevent duplicate cost basis reporting. Specifically, under Treas. Reg. § 1.6045-1(c)(3)(iii), only the broker responsible for paying a shareholder who has redeemed shares will report gross proceeds and cost basis under section 6045.

B. *Forms*

The Form 1099 and Schedule D obviously will need to be amended to reflect the Legislation. Among other things, these forms and schedules will need to inform the IRS and shareholders: (1) whether or not securities are "covered securities" subject to reporting; (2) that information has been supplied to the broker by the shareholder; (3) of those securities for which a default basis has been used (if reporting voluntarily is provided, for example, for gifted and inherited shares); and (4) whether the shareholder is using the cost basis provided by the broker (perhaps with an explanation why not, if that is the case). A working group of Institute members and others is reviewing the forms and discussing what changes should be made; we hope to provide comments on the forms soon.

C. *Obligation to Amend Forms 1099*

The Institute recommends that the IRS take advantage of the opportunity provided by cost basis reporting to address the ongoing burden arising from the apparent requirement to amend Forms 1099 for *de minimis* changes. IRS also should consider whether it is appropriate to provide a cut-off date, such as June 30 of next calendar year, for amending prior-calendar-year tax information (unless, perhaps, the error is substantial). These changes would simplify tax reporting, substantially reduce the likelihood of amended individual income tax returns, and have (at most) a very modest impact (which could be positive or negative) on tax collections. Indeed, the administrative cost savings to the IRS almost surely would exceed any "lost" revenues.

Forms 1099 today are amended routinely if the tax character of a distribution changes (*e.g.*, it initially was classified as a dividend but becomes in part a return of capital) or the information otherwise is incorrect.[48] Every year during the tax reporting season, news stories discuss the prevalence of amended Forms 1099 sent by brokers and funds. These amended forms can impose significant costs

[48] There is some uncertainty, at least academically, whether a payor is required by current law to send payees amended information statements that the payor believes are accurate when sent. In fact, payors do send amended statements, among other reasons, so that they can satisfy a condition of the reasonable cause exception from penalties for errors made later.

on brokers, investors, and the IRS (including costs of processing amended Forms 1099 information returns filed by brokers and Form 1040 tax returns filed by investors). Amended forms also create substantial investor confusion and frustration, particularly if the shareholders already have filed their tax returns for that year.

Because mandatory cost basis reporting increases significantly the amount of information that must be reported to shareholders and the IRS, and for other reasons, it is likely that more Forms 1099 will be amended, all of which the IRS will need to process. To reduce the burden on brokers, taxpayers, and the government, the Institute recommends that the IRS provide a *de minimis* rule for amended Forms 1099. This *de minimis* rule should provide that a broker is not required to amend a customer's Form 1099 if the aggregate adjustment from the income initially reported (or the basis, in the case of gross proceeds reporting) is $10 or less.[49] This suggestion is consistent with the current law provision that exempts payers from filing information returns for dividends and interest totaling less than $10.[50] Congress clearly recognized that the value of the information to the shareholder in such cases is outweighed by the burden to the payer and the IRS; the same logic should apply to amendments.

D. *Clarification of February 15 Deadline*

We urge the IRS to define promptly, and consistently with Congressional intent, the term "consolidated reporting statement." This term is important for purposes of the amendment to section 6045(b) that allows statements to be sent to customers by February 15, rather than January 31. Specifically, the Legislation provided that,

> [i]n the case of a consolidated reporting statement (as defined in regulations) with respect to any customer, any statement which would otherwise be required to be furnished on or before January 31 of a calendar year with respect to any item reportable to the taxpayer shall instead be required to be furnished on or before February 15 of such calendar year if furnished with such consolidated reporting statement.

This new reporting deadline became effective for statements required to be furnished after December 31, 2008.

After the Legislation was enacted, some confusion arose regarding the scope of the deadline extension; some thought that the extension applied only to Forms 1099-B or, at most, only to broker statements that included a Form 1099-B. The IRS addressed this confusion by issuing Notice 2009-11,

[49] Under this approach, an amendment statement would not be required for a $9 error. If an error of $2 (in the same direction) were discovered subsequently, the broker would be required to amend the Form 1099 and report the $11 (cumulative) error.

[50] *See* sections 6042(a)(1) (returns regarding payments of dividends) and 6049(a) (returns regarding payments of interest).

which stated that the new deadline applied to "an annual composite form recipient statement," as described in section 4.2 of Rev. Proc. 2008-36. Although this guidance made it clear that the February 15 deadline applied to statements for dividends, interest, OID, and royalties, as well as gross proceeds, it still was not clear whether the new deadline also applied to retirement income information.[51]

The industry uses the term "consolidated reporting statement" to mean all tax information provided to a customer in a single envelope, regardless of the number of sheets of paper included and the types of accounts (*e.g.,* taxable or retirement) that the customer has with the firm.[52] As used by the industry, the term "consolidated reporting statement" encompasses, for example, a statement including Forms 1099-B, 1099-DIV, 1099-INT, 1099-R, 1099-Q, 5498 and 5498-ESA.

The Institute strongly supported the February 15 reporting deadline during the legislative process and urged that the deadline apply to all tax information provided in a single envelope. We explained to staff that applying the extended deadline only to certain statements, rather than all statements sent in one envelope, effectively would negate the ability of firms in the mutual fund industry to use the extended deadline. Sending tax information to one customer on multiple statements at different times would be costly and confusing to customers; the likely result would be that all statements would be sent by January 31.

The Legislation's language reflects the Institute's concerns and is intended to apply to a consolidated reporting statement as that term is used by the industry.[53] In fact, the JCT Bluebook states that the statements to which the new February 15 deadline applies are (1) statements showing gross proceeds or substitute payments, and (2) statements with respect to reportable items (including, but not limited to, interest, dividends, and royalties) that are furnished with consolidated reporting statements.[54] Further, the JCT Bluebook notes that

[51] One of the industry service providers spoke with an attorney at the IRS, who confirmed that, for the 2008 taxable year, such retirement account statements could be sent with the Form 1099-B by the February 15 deadline. This attorney stated that the IRS had been unaware that forms other than the Form 1099-DIV and 1099-INT were sent with the Form 1099-B on a consolidated statement. Despite this verbal confirmation, we believe that many of the Institute's members simply asked for a 31-day extension to the January 31 deadline to ensure that all statements were timely sent.

[52] For these purposes, the "firm" may include parties such as the fund or its transfer agent (reporting fund investments through taxable accounts) and a trust company (reporting fund investments through an individual retirement account).

[53] In an April 2008 draft of the House bill, the provision applied to a consolidated reporting statement with respect to any "account." The Institute explained that currently information with respect to multiple accounts belonging to the same customer is sent together. When the Legislation was enacted, it referred to a consolidated reporting statement with respect to any "customer."

[54] JCS-1-09, p. 366.

> [t]he term "consolidated reporting statement" is intended to refer to annual account information statements that brokerage firms customarily provide to their customers and that include tax-related information. It is intended that the February 15 deadline for consolidated reporting statements apply in the same manner to statements furnished for any account or accounts, taxable and retirement, held by a customer with a mutual fund or other broker.[55]

Thus, IRS should clarify well in advance of the next tax reporting season that, as intended by Congress, the February 15 reporting deadline applies to all information statements sent to a customer in one envelope, including information for both taxable and nontaxable accounts.

E. *Reporting to S Corporations*

The Institute suggests a few relatively modest changes to improve the administrability of the section 6045(g)(4) requirement that cost basis reporting apply to shares acquired by an S corporation after December 31, 2011. This new requirement will create significant difficulties for the industry because, prior to the legislation, tax reporting was not required for these entities. Specifically, S corporations were treated, under Treas. Reg. § 1.6045-1(c)(3)(i)(B), as "exempt recipients." As such, brokers were not required to send them information statements.

RICs currently do not know which of their existing corporate customers are S corporations whose post-effective-date shares will be subject to cost basis reporting. As the IRS is aware, S corporations typically do not use any special type of name or label that identifies them as such. Firms will be required to contact all of their corporate clients and attempt to discern which will be subject to the new reporting requirement.

Despite the funds' best efforts, there will be corporate shareholders who do not respond to requests for their corporate status. The Treasury and the IRS should provide guidance on brokers' reporting obligations in such cases.

In addition, to improve tax compliance going forward, the Institute recommends that the IRS promptly amend Form W-9 to provide an additional box where a shareholder can identify itself as an S corporation. This change will assist funds, which typically include the Form W-9 certifications in their account opening documents. Requiring shareholders to make this identification on the W-9 will permit brokers to rely upon a certification that the shareholder has signed under penalties of perjury. By amending the W-9 promptly, brokers will be able to minimize the number of corporate clients whose status as an S corporation or a C corporation will need to be determined.

[55] *Id.*

If an S corporation misidentifies itself, (either on the W-9 or at the broker's request), a RIC will have no way of knowing that the information is incorrect. In such cases, a RIC should not be subject to penalties for failure to report to an S corporation that does not correctly identify itself as such to its broker.

VI. Record Retention

The Institute recommends that Treasury regulations clarify that brokers will be required to retain information for redeemed shares for only three years from the due date for the information return reflecting that redemption (four years if the distribution was subject to backup withholding). This recommendation is consistent with the rule that applies to other information reporting statements.[56]

We make this recommendation because storing shareholder transaction records is space-intensive and costly. Clearly, all relevant share lot history (*e.g.,* date of purchase, cost, and number of shares) must be kept until shares are redeemed. Unless the average cost basis method is selected (and cannot be changed),[57] all lot history, other than history that funds are permitted to purge from their systems, will still need to be stored until the account is closed. Given the volume of information that brokers must now maintain, it will be helpful for IRS to confirm the period for which cost basis information on redeemed shares must be maintained.

VII. Penalty Relief

The Institute recommends that IRS provide express information reporting penalty relief for the situations described below. For example, brokers that choose to provide customers with cost basis information for shares that are not "covered securities" subject to reporting should not be liable for information that was gathered, and provided, voluntarily. The same relief also should be provided for pre-effective date data that is reported because an election is made to combine "pre- and post-effective date shares" in a single account. Similarly, brokers should not be penalized for reporting data over which they have no control, such as cost basis data received from an unrelated source (*e.g.*, another broker or a shareholder) or for not reporting data because of reliance upon an inappropriate customer certification that the customer was exempt from reporting. Finally, despite the industry's best efforts to

[56] Treas. Reg. § 1.6001-1(e) requires any person required to file an information return to keep the books and record relating to such return "so long as the contents thereof may become material in the administration of any internal revenue law." Rev. Proc. 2008-30, Part A, Section 7.01, clarifies that payers should retain a copy of the information returns filed with the IRS or have the ability to reconstruct the data for at least three years from the reporting due date (four years for returns when backup withholding is imposed or with respect to Form 1099-C).

[57] If the average cost method is selected, the amount of data that must be maintained is reduced somewhat. For all shares held for more than the minimum long-term holding period (one year), only the number of shares and cumulative cost basis need be maintained. For shares held for one year or less, all transaction history must be maintained.

implement the cost basis reporting requirements in a timely and efficient manner, problems undoubtedly will arise, particularly during the early years after cost basis reporting is implemented. Therefore, appropriate penalty relief should be provided.

A. *Combining Pre- and Post-Effective Date Data*

The IRS should provide penalty relief for data regarding pre-effective shares if the election is made to combine pre- and post-effective date data under section 1012(c)(2)(B). We anticipate that brokers will not make this election unless they are relatively confident that their pre-effective date data is reliable. Nevertheless, they may be disinclined to make this election without express penalty relief for information gathered before the cost basis reporting requirements were enacted. Providing such relief may encourage more brokers to make the election to combine RIC accounts, which could benefit both shareholders and the IRS.

B. *Data Provided by Shareholder or Third Party*

The IRS should provide penalty relief for reported cost basis information that brokers did not calculate themselves. For example, a broker may receive cost basis information from another broker when a shareholder transfers his or her securities. Also, if a shareholder receives securities as a gift or inheritance, the shareholder may provide the broker with the adjusted basis for those securities. In these types of situations, the broker should not be responsible for the accuracy of the basis information provided.

Further, brokers should not be required to review the accuracy of the basis information received from others. Manual review of transferred cost basis information (even if the review were limited to information transferred through "non-electronic" means) would be extraordinarily time consuming and expensive. Moreover, assuming (hypothetically) that an automated system could be built and administered to review all information transferred electronically, this task would be difficult (at best) and effectively would require brokers to act as deputized IRS auditors. The responsibility for auditing tax information generated by others should remain where it is today – on the IRS.

C. *Reporting to S Corporations*

Brokers should not be subject to penalties for failures to report to S corporations that do not correctly identify themselves as such. For both existing and new accounts, brokers must rely upon the information provided to them by corporate shareholders to determine whether reporting is necessary. If a corporate shareholder does not identify itself as an S corporation, a broker will have no reasonable means for determining whether the shareholder is in fact an S corporation. Once again, the responsibility for auditing tax information generated by others should remain where it is today – on the IRS.

D. *Transition Period*

The IRS should provide broad penalty relief for cost basis reports, at least for an interim period, because of the enormous burdens, discussed above, that mandatory cost basis reporting will impose on the industry. Extensive changes must be made to current systems, while others must be built from scratch. Although brokers have until 2012 to implement these systems for fund shares, considerable building and testing must be completed. Significant shareholder education also will be required. Even after the systems are on line, problems undoubtedly will arise; kinks will need to be worked out. Any broker that takes seriously the new obligations imposed by the Legislation should not have to worry that an IRS agent later will second guess whether the broker had a reasonable basis for errors committed during this tumultuous period. At a minimum, this transition relief should be provided for three years after the broker first reports cost basis for shares acquired after the Legislation's effective date.

* * *

The Institute appreciates the opportunity to comment on this important new reporting requirement. We look forward to discussing it further with the IRS and Treasury Department and will contact the IRS soon to request a meeting. In the meantime, should you have any questions, please contact me at (202) 371-5432 or kgibian@ici.org.

Sincerely,

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