

MEMO# 22916

October 3, 2008

Economic Stabilization Bill Enacted Today Includes Cost Basis Reporting, Flow-Through Extension, And Other Provisions

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 31-08

BROKER/DEALER ADVISORY COMMITTEE No. 37-08

FEDERAL LEGISLATION MEMBERS No. 13-08

OPERATIONS MEMBERS No. 17-08

PENSION MEMBERS No. 60-08

SMALL FUNDS MEMBERS No. 61-08

TAX MEMBERS No. 40-08

TRANSFER AGENT ADVISORY COMMITTEE No. 59-08 RE: ECONOMIC STABILIZATION BILL
ENACTED TODAY INCLUDES COST BASIS REPORTING, FLOW-THROUGH EXTENSION, AND
OTHER PROVISIONS

The economic stabilization legislation signed into law today by President Bush (the "Act") [\[1\]](#) includes a provision requiring brokers (including mutual funds) to report cost basis information to shareholders and the Internal Revenue Service (the "IRS"). [\[2\]](#) The Act also (i) extends several tax provisions that expired at the end of 2007, including the flow-through of interest and short-term capital gains to foreign investors [\[3\]](#) and the income exclusion for charitable distributions from individual retirement accounts ("IRAs"), [\[4\]](#) (ii) modifies the standard for certain tax return preparer penalties, [\[5\]](#) and (iii) extends tax and benefits relief to certain Midwestern disaster areas. [\[6\]](#)

Cost Basis Reporting

Section 403 of the Act's Division B amends Internal Revenue Code (the "Code") section

6045 to require brokers, including mutual funds, to report to customers and the IRS the customers' cost basis in securities (including mutual fund shares) sold or redeemed. Brokers also are required to report the long-term or short-term nature of any gain or loss.

The legislation includes a few important changes from previous bills that were urged by the ICI and others and are discussed in greater detail below. First, the cost basis reporting provisions generally apply to fund shares one year after they apply to other stocks. Second, the reporting deadline for sending year-end tax information to customers generally is extended from January 31 to February 15.

The Act applies to shares in all regulated investment companies ("RICs") – both mutual funds and closed-end funds – acquired on or after January 1, 2012; [\[7\]](#) as urged by the ICI and others, this effective date is one year later than the January 1, 2011 date that applies to other stocks. [\[8\]](#) Unlike earlier cost basis reporting proposals, which would have provided three different reporting regimes for fund shares, [\[9\]](#) the Act's provision effectively creates two reporting regimes: One for fund shares acquired before January 1, 2012, and one for shares acquired thereafter. Under the legislation, fund shareholders have no obligation to use any cost basis information provided voluntarily for shares acquired through 2011, but generally are required to use the cost basis information provided for shares acquired thereafter.

In the case of funds, the shareholder's cost basis of post-effective date shares is determined "in accordance with the broker's default method unless the customer notifies the broker that he elects another acceptable method under [Code] section 1012 with respect to the account in which such stock is held." [\[10\]](#) A fund may determine cost basis for shares acquired after the effective date under average cost, first-in/first-out, or any method (such as highest-in/first-out) that involves identification of specific shares. Shares of funds acquired before and after January 1, 2012, are treated as in different accounts, unless the fund elects to treat all of a customer's shares as in one account. Thus, for example, a mutual fund could provide cost basis information under (i) the average cost method (for pre-effective-date shares, on which reporting would be voluntary), and (ii) a form of specific identification, such as highest-in/first-out (for post-effective-date shares, on which reporting would be mandatory). At the ICI's urging, the treatment of shares acquired before and after the effective date as separate accounts now applies to both open-end and closed-end funds; in prior versions, this provision applied only to open-end funds. [\[11\]](#)

The deadline for sending year-end tax information to customers generally is extended from January 31 to February 15. The extension applies to all shares held by a customer, whether or not the account included a transaction for which cost basis reporting was required. At the ICI's request, this is a slight change from the bill passed by the House in May, [\[12\]](#) which applied to all shares in an account. The 15-day reporting extension applies to statements required to be furnished to customers after December 31, 2008.

The Act provides a limited exception from the wash sale rule of Code section 1091. Specifically, brokers must apply the wash sale rule for reporting purposes only if the transactions occurred in the same account with respect to identical securities. This provision, like the other cost basis reporting changes (other than the February 15 reporting change), generally takes effect on January 1, 2011.

Reporting to S corporations is required if the shares were acquired after December 31, 2011. The S-corporation reporting provision also was included in the bill passed by the House in May. [\[13\]](#)

The legislation applies to fund shares acquired after the effective date if the shares were (i) acquired through a transaction in the account or (ii) transferred to such account from another account in which the shares were covered by the basis reporting requirement, but only if the broker received a statement under new Code section 6045A with respect to the transfer.

New Code section 6045A requires brokers who transfer securities to another broker to furnish to the transferee a written statement setting forth such information as prescribed in regulations for purposes of enabling the transferee to meet the basis reporting requirements. The statement must be furnished no later than the earlier of 15 days after the date of the transfer or January 15 of the year following the calendar year in which the transfer took place. The legislation also imposes a penalty on a transferring broker who fails to furnish the written statement

Flow-Through and FIRPTA

Section 206 of the Act's Division C extends for two years the exemption from withholding taxes for interest and short-term capital gains paid by RICs to foreign shareholders under Code section 871(k)(1) and (2). [\[14\]](#) This provision applies to dividends with respect to taxable years of RICs beginning after December 31, 2007.

Section 207 of the Act's Division C extends for two years the provision under Code section 2105(d) that treats stock in certain RICs as not deemed property within the United States for purposes of determining the estate of a nonresident not a citizen. This provision applies to decedents dying after December 31, 2007.

Section 208 of the Act's Division C extends for two years to RICs certain REIT-related provisions of Code section 897 (the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA). [\[15\]](#)

Distributions from IRAs for Charitable Purposes

The Pension Protection Act of 2006 provided an income exclusion of up to \$100,000 for qualifying distributions from IRAs paid to certain charitable organizations and made on or after the IRA owner attains age 70 ½. [\[16\]](#) The exclusion was available only for distributions in the 2006 and 2007 tax years. Section 205 of the Act's Division C extends the provision for two years, which now applies to qualified charitable distributions made in taxable years beginning on or before December 31, 2009.

Tax Return Preparer Penalties

Section 506 of the Act's Division C amends Code section 6694(a) to modify the authority standards applicable to paid preparer penalties for understatement of a taxpayer's liability. Specifically, the Act provides that paid preparers, like taxpayers under current law, are not subject to penalties for undisclosed positions so long as substantial authority supported the positions. Under legislation enacted in May 2007, the authority standard applicable to paid preparers was the higher "more likely than not" standard. The provision applies to returns prepared after May 25, 2007.

Disaster Relief

Title VII of the Act's Division C includes a variety of provisions to provide relief for businesses and individuals affected by Hurricane Ike and recent flooding in the Midwest.

Section 702 provides that the tax and benefits relief provided under Code section 1400Q for Hurricane Katrina victims applies for certain Midwestern disaster areas (but not for Hurricane Ike).

Karen Lau Gibian
Associate Counsel – Tax Law

Michael L. Hadley
Associate Counsel – Pension Regulation

endnotes

[1] The legislation (H.R. 1424) – see http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424eas.txt.pdf – passed the Senate on October 1 and the House on October 3; the Act consists of three separate “divisions”: the “Emergency Economic Stabilization Act of 2008” (“Division A”); the “Energy Improvement and Extension Act of 2008” (“Division B”); and the “Tax Extenders and Alternative Minimum Tax Relief Act of 2008” (“Division C”).

[2] See Section 403 of Division B, pp. 238 - 253 of the Act.

[3] See Sections 206-208 of Division C, pp. 263 - 264 of the Act.

[4] See Section 205 of Division C, p. 263 of the Act.

[5] See Section 506 of Division C, pp. 301 - 303 of the Act.

[6] See Sections 701 et seq. of Division C, pp. 385 et seq. of the Act.

[7] Specifically, the January 1, 2012 effective date applies “in the case of any stock for which an average basis method is permissible under [Code] section 1012.”

[8] The effective dates in the Act are one year later than those in the bill passed by the House in May. See Institute [Memorandum](#) (22506) to Bank, Trust and Recordkeeper Advisory Committee No. 15-08, broker/Dealer Advisory Committee No. 14-08, Federal Legislation Members No. 6-08, Operations Members No. 6-08, Small Funds Members No. 31-08, Tax Members No. 16-08, and Transfer Agent Advisory Committee No. 26-08, dated May 13, 2008.

[9] See, e.g., Institute [Memorandum](#) (21952) to Bank, Trust and Recordkeeping Advisory Committee No. 50-07, Broker/Dealer Advisory Committee No. 71-07, Federal Legislation Members No. 11-07, Operations Members No. 25-07, Small Funds Members No. 107-07, Tax Members No. 50-07, and Transfer Agent Advisory Committee No. 80-07, dated November 14, 2007.

[10] For other securities, cost basis is determined using the first-in/first-out method unless the customer adequately identifies the specific shares of stock to be sold.

[11] See, e.g., Institute [Memorandum](#) (22506), footnote 8, *supra*. This provision now applies to “any stock for which an average basis method is permissible under [Code] section 1012.”

[\[12\]](#) See id.

[\[13\]](#) See id.

[\[14\]](#) See Institute [Memorandum](#) (18115) to Tax Members No. 42-04, International Members No. 55-04, and Accounting/Treasurers Members No. 35-04, dated October 19, 2004.

[\[15\]](#) See id.

[\[16\]](#) See Code section 408(d)(8). For more information on the Pension Protection Act of 2006, see Institute [Memorandum](#) (20250) to Pension Members No. 48-06, Federal Legislation Members No. 5-06, and 529 Plan Members No. 13-06, dated August 4, 2006.

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