

MEMO# 21321

July 2, 2007

ICI Submission To Senate Finance Committee Staff on Cost Basis Reporting

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TO: TAX MEMBERS No. 28-07
OPERATIONS MEMBERS No. 11-07
FEDERAL LEGISLATION MEMBERS No. 3-07
SMALL FUNDS MEMBERS No. 50-07
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 17-07
BROKER/DEALER ADVISORY COMMITTEE No. 29-07
TRANSFER AGENT ADVISORY COMMITTEE No. 39-07 RE: ICI SUBMISSION TO SENATE
FINANCE COMMITTEE STAFF ON COST BASIS REPORTING

The Institute has submitted comments (attached) to the Senate Finance Committee staff on the staff's draft cost basis reporting proposal (the "Staff Draft"). [\[1\]](#) The Institute's submission contains a number of technical and operational recommendations that were developed during extensive discussions with representatives from various tax and operations committees, third-party transfer agents, and the Depository Trust and Clearing Corporation.

The Institute's submission emphasizes three main points:

1. Any mandatory basis-reporting regime must be administrable and effective for shareholders, funds, brokers and other distributors, and the government;
2. Sufficient time must be provided to ensure that the necessary programming and systems challenges are addressed effectively; and
3. The flexibility under current law that allows mutual funds and their shareholders to

compute cost basis under any available method must be maintained.

The submission first describes current practices in the industry for providing and maintaining basis information and the systems necessary to do so. Absent special rules, the submission explains, a basis reporting requirement on shares acquired after a certain date would require the inclusion of pre-effective date shares in the calculation of average cost on new shares in existing accounts. Several specific recommendations are made regarding the effective date of the Staff Draft, the application of a basis-reporting regime to existing accounts and accounts with transferred shares, changes to certain statutory basis adjustments that will reduce the need for amended Forms 1099, an extended reporting date, and other issues.

Effective Date

A sufficiently delayed effective date is needed to give funds time to build, program and test the systems necessary to report cost basis. Further, the cost basis regime should be applied on a calendar-year basis, rather than mid-year, to ease the transition and administration of the new rules. Finally, funds must know their cost basis calculation and reporting obligations before they can finalize necessary systems changes. For these reasons, the Institute recommends that the Staff Draft apply to returns the due date for which is the later of:

- December 31 of the calendar year that ends more than 18 months after the date of enactment, or
- December 31 of the first calendar year that ends at least 12 months after the issuance of final regulations by the Secretary.

This requirement would apply with respect to securities acquired in or after the calendar year ending on the later of such dates.

Application to Accounts for which Cost Basis is Reported Currently

Absent special rules, the Staff Draft's effective date requires the cost basis of pre-effective date shares in an existing account be included in computing the cost basis of post-effective date shares if the fund reports basis under the average cost method. Guidance therefore is necessary regarding how funds will report this pre-effective date basis and the extent to which information reporting penalties will apply.

The Institute understands that some funds will prefer to continue reporting average cost basis information voluntarily to shareholders, but not to the Internal Revenue Service (the

“IRS”), on pre-effective date shares. This information may be provided to shareholders on Forms 1099. Some funds, in contrast, will prefer to provide average cost basis information voluntarily on Forms 1099 to both shareholders and the IRS for pre-existing shares. Therefore, the Institute recommends that the Committee Report to any basis reporting legislation confirm that voluntary reporting on pre-effective date shares is not subject to information reporting penalties, even if the cost basis is reported to shareholders and/or the IRS on the IRS Form 1099. The Committee report also should clarify that any errors resulting from the inclusion of the cost basis of pre-effective date shares in determining the average cost basis of post-effective date shares will be deemed to be attributable to reasonable cause. Further, the Committee Report should clarify that the reasonable cause penalty standard does not require funds, with respect to the cost basis of post-effective date shares, to re-examine the cost basis of the pre-effective date shares.

Application to Accounts for which Cost Basis is Not Reported or Available Currently

Although most funds provide basis information to a substantial number of their customers, there are accounts for which cost basis is not reported or available currently. These include accounts opened before cost basis was provided voluntarily, accounts that include “internally transferred” shares (i.e., re-registered shares) or “externally transferred” shares (i.e., transfers of an account between a broker and the fund, or between brokers), or accounts in funds that do not provide basis information to any customers currently. Without creating a new account, it is not clear how a fund should calculate an average cost for post-effective date shares in the account without knowing the cost basis of the pre-existing shares.

Based on discussions with members, the Institute understands that members are considering two options for applying the basis reporting requirements to existing accounts for which cost basis is not reported or available currently. The first option would presume that shareholders would redeem shares from an account on a first-in, first-out basis (the “FIFO presumption”) until all of the pre-effective date shares have been redeemed. At that point, the fund would be able to compute an average cost for the post-effective date shares remaining in the account. Thereafter, the fund would report average cost basis in compliance with the cost basis reporting legislation.

For situations in which the FIFO presumption is applied, the Institute recommends that the Committee Report instruct the Treasury Department to amend the cost basis reporting regulations to clarify that a fund may exclude the pre-effective date shares when calculating basis on the post-effective date shares. It also should clarify that funds would have no reporting obligation with respect to pre-effective date shares.

The Institute also understands that a limited number of funds may wish, on an account-by-account basis, to reconstruct retroactively the cost basis on shares for which cost basis reporting currently is not provided. The reconstructed basis would be used to report

average cost with respect to both old and new shares. For these situations, the Institute recommends that the Committee Report provide that a fund using good faith efforts to reconstruct basis would have reasonable cause for any errors in the reconstruction. In addition, the Committee Report should provide that funds have reasonable cause to report cost basis by reference to information provided by shareholders. The funds would have an obligation, however, to determine if the information provided was facially reasonable; if not, the fund could report and rely upon the basis information provided, so long as the determination of unreasonableness was reported to the shareholder and the IRS.

Internal Transfers

Re-registration of shares within an individual fund (i.e., when the name and tax identification number on the account are changed) may result from gifts, inheritances, or transfers for value. The basis rules for such transfers can be complicated and can turn upon facts unknown to the fund. Therefore, the Institute recommends that the Staff Draft be modified to provide default rules for re-registrations. Unless the fund has actual knowledge that shares have been inherited, funds should apply a default rule that treats as the cost basis of the re-registered shares the carry-over cost basis of the shares. If the fund knows that the shares have been inherited, the default rule should be a full stepped-up basis (i.e., fair market value) 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. Funds should have clear statutory authority to override the default rule if the new account owner provides relevant additional information.

The Institute also recommends that the Committee Report provide that funds have reasonable cause to report cost basis by reference to information provided by shareholders. Further, the IRS should amend reporting forms to allow funds to disclose that transferred shares have been included in a cost basis calculation, alerting shareholders and the IRS that at least part of the information may have been subject to the default rule.

External Transfers

When mutual fund positions are transferred from a fund to a broker, from a broker to a fund, or from a broker to another broker, the transferee institution should be able to rely upon the basis information provided by the transferring institution. Otherwise, the transferee institution will want to calculate and verify the basis information itself, which would require transfers of complete share lot history. Accordingly, the Institute recommends that the Committee Report clarify that transferees may rely upon information provided by transferors without any obligation to independently verify the information received. A transferee should be able to treat all shares for which cost basis information is not provided by the transferor as pre-effective date shares. If cost basis information is not provided, the transferee would have the obligation to request the cost basis information from the transferor and then inform the shareholder and the IRS if the information

subsequently is not transferred.

Basis Adjustments

The Internal Revenue Code contains several basis adjustment rules that may require funds to send amended Forms 1099 to shareholders months or years after the original forms have been sent. To eliminate unnecessary amended Forms 1099, the Institute recommends the following statutory changes:

- **Wash Sales.** Section 1091 should be amended to disregard any shares (a) purchased in January of the year following the year in which shares were redeemed at a loss from an open-end regulated investment company on which basis reporting is required the Staff Draft, provided that (b) either (i) the shares were purchased pursuant to a dividend reinvestment plan or (ii) the amount of the loss that would be disallowed by section 1091 is \$25 or less.
- **Sales Load Basis Deferrals.** Section 852(f) should be amended to provide that the load basis deferral rule would not apply if a fund shareholder acquired shares in the new fund for which the load was waived after January 31 of the calendar year following the calendar year in which the shareholder disposed of its shares in the fund for which the load was originally paid.
- **Returns of Capital.** Section 316(b) should be amended to provide that funds may allocate returns of capital first to distributions made during the portion of the fund's taxable year occurring during the calendar year in which the taxable year ends.

Holding Period

The Staff Draft requires that brokers provide "such information as necessary to determine the customer's holding period with respect to" the shares sold or redeemed. The Institute recommends that the Committee Report clarify that the holding period need be reported only as either "short-term" (held for 12 months or less) or "long-term" (held for more than 12 months). In addition, the Committee Report should clarify that funds may rely upon the holding period information provided to them by another party in connection with a transfer of shares.

Electronic Transmittal

The Staff Draft provides that, when shares are transferred to a broker, the transferring broker "shall furnish ... a written statement in such manner and setting forth such information as the Secretary may by regulations prescribe." The Institute recommends that the Committee Report clarify that the written statement requirement may be satisfied by electronic transmittal.

Extended Reporting Date

Because the Staff Draft will impose significant new responsibilities on funds, the Institute recommends that the tax reporting deadline be extended from January 31 to February 15, as proposed in S. 636, the Reduce Wasteful Tax Forms Act of 2007, introduced by Senator Charles Schumer earlier this year. [\[2\]](#)

Questions regarding legal or operational cost basis reporting issues can be directed to the undersigned at 202/371-5432 or kgibian@ici.org, to Keith Lawson (Senior Counsel-Tax Law) at 202/326-5832 or lawson@ici.org, to Kathy Joaquin (Director-Operations & Distribution) at 202-326-5930 or kjoaquin@ici.org, or to Marty Burns (Director-Institutional Operations & Service) at 202/326-5980 or mburns@ici.org.

Karen Lau Gibian
Assistant Counsel

[Attachment](#)

endnotes

[\[1\]](#) See Institute [Memorandum](#) (21238) to Bank, Trust and Recordkeeper Advisory Committee No. 15-07, Broker/Dealer Advisory Committee No. 24-07, Tax Committee No. 26-07, and Transfer Agent Advisory Committee No. 32-07, dated June 13, 2007, and Institute [Memorandum](#) (21249) to Operations Committee, No. 11-07, dated June 14, 2007.

[\[2\]](#) See Institute [Memorandum](#) (20880) to Bank, Trust and Recordkeeper Advisory Committee No. 7-07, Broker/Dealer Advisory Committee No. 11-07, Operations Members No. 8-07, Tax Members No. 10-07, and Transfer Agent Advisory Committee No. 10-07, dated February 16, 2007.