The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Final Regulations on Cost Basis Reporting

[24610]

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 40-10
BROKER/DEALER ADVISORY COMMITTEE No. 47-10
OPERATIONS MEMBERS No. 13-10
SMALL FUNDS MEMBERS No. 60-10
TAX MEMBERS No. 31-10
TRANSFER AGENT ADVISORY COMMITTEE No. 66-10 RE: FINAL REGULATIONS ON COST BASIS REPORTING

As we previously informed you, [1] the Internal Revenue Service ("IRS") and Treasury Department recently released final regulations implementing cost basis and other information reporting requirements for brokers, including mutual funds. These reporting requirements were enacted by the Energy Improvement and Extension Act of 2008, and the government issued proposed regulations in December 2009.

We are pleased to report that the final regulations incorporate many of the comments made by the Institute and its members. [2] The final regulations clarify several open issues raised by the industry and address a number of concerns in a manner that will facilitate implementation and administration of the cost basis reporting requirements.

Basis Determination Using Average Cost

1. Making the Average Cost Election

The final regulations retain the requirement in the proposed regulations that taxpayers must make an average cost election in writing. The written election must identify each account and the stock in the account to which the election applies. As recommended by the Institute, however, the final regulations clarify that a written election can be made electronically. Further, the final regulations adopt the Institute's suggestion that a taxpayer be permitted to make one average cost election that applies to all eligible accounts with a broker, including any future accounts.

The IRS also clarified that the written requirement only applies to a taxpayer's election to use average cost and does not prevent a broker from using average cost as its default

method.

The final regulations specify that a taxpayer who fails to affirmatively elect average cost as its basis method has not made an election of a basis method. Thus, if average cost is the broker's default method, the taxpayer has not made an average cost election that it can revoke, and the taxpayer may change from average cost prospectively only. Any shares in the account prior to the change in method will be treated as having the same basis as that before the change (i.e., the average cost of the shares).

2. Transition Rule from Double-Category Average Cost

The final regulations eliminate the double-category average cost method, as was proposed. The proposed regulations provided a transition rule for stock for which a taxpayer uses the double-category method that was to be effective on the date of the final regulations. As requested by a commentator, the final regulations delay the effective date for the transition rule to April 1, 2011.

3. Change in Basis Method

As requested by the Institute, the final regulations provide that a basis determination method, including the use of average cost, is not a method of accounting. Therefore, a change in method of determining basis is not a change in method of accounting to which sections 446 and 481 apply. The final regulations thus permit taxpayers to elect or change from average cost at any time during a taxable year and to choose a method to identify stock sold on a sale-by-sale basis. This rule applies to both pre-effective and post-effective date shares. [3] The final regulations require the taxpayer to notify the custodian or agent holding the stock in writing, by any reasonable means, of the taxpayer's intent to change from average cost to another method. Once a taxpayer changes from average cost to another method, the basis of each share of stock already in the account to which the change applies remains the same as the basis immediately before the change (i.e., the average cost).

4. Account by Account Rules

The proposed regulations provided that regulated investment company ("RIC") or dividend reinvestment plan ("DRiP") stock acquired before January 1, 2012, is treated as held in a separate account from RIC or DRiP stock acquired on or after that date. The proposed regulations also provided that covered and noncovered securities are treated as held in separate accounts. Because these two rules are duplicative, the final regulations eliminate the rule based on acquisition date and retain only the rule for covered and noncovered securities.

5. Single Account Election

The final regulations clarify several issues regarding brokers' single account election. First, the regulations provide that a single-account election only applies to accounts with the same ownership. Thus, a broker cannot make an election to combine an account held solely by a shareholder with an account held jointly by the same shareholder and the shareholder's spouse.

The final regulations also respond to comments made by the Institute regarding the effect on the single account election of a shareholder's revocation of or change from average cost to another method. The final regulations provide that a taxpayer's revocation of an average cost election voids the broker's single account election for that stock. Thus, brokers must retain individual lot information for shares in an account for which the single

account election is made until the revocation period for that account has ended. [4] Stock that becomes a covered security only as a result of a single account election is no longer a covered security after the single account election is voided due to a revocation.

The final regulations also provide that if a taxpayer changes from average cost to another method, as recommended by the Institute, the shares that were treated as held in a single account before the change continue to be covered securities after the change. The basis of each share of stock in that account at the time of the method change remains the same as the basis immediately before the change (i.e., the average cost of the shares).

The Institute and others asked the IRS to eliminate the accuracy requirement for the single account election contained in the proposed regulations. The IRS did not adopt this change. The final regulations thus retain the accuracy requirement and the "neither knows nor has reason to know" standard. The government believes this test strikes an appropriate balance between the need for accuracy and flexibility and is consistent with existing standards for demonstrating reasonable cause for penalty relief under the information reporting penalties.

6. Unit Investment Trusts

Under current law, [5] a unit investment trust ("UIT") that is a RIC is permitted to use average cost only if it meets certain requirements. A commentator asked the IRS to amend the regulations to permit all UITs that elect to be treated as RICs to use the average cost method. The final regulations do not adopt this suggestion, but the IRS may consider it for future guidance.

Other Basis Determination Issues

1. Use of an Agent

The Institute and other commentators asked the IRS to clarify whether a taxpayer's agent, such as an asset manager or investment advisor, could select a basis method on behalf of the taxpayer. The final regulations do not explicitly provide for the use of an agent, but the Preamble to the regulations notes that a taxpayer may authorize an agent to select a basis determination method under general agency principles.

2. Cost Basis of Multiple Lots Purchased on One Day

The final regulations provide that if a taxpayer purchases identical stock at separate times on the same calendar day in executing a single trade order, and the broker executing the trade provides a single confirmation that reports an aggregate total cost or an average cost per share, then the taxpayer must determine the basis of such stock by averaging the cost of each share. A taxpayer may determine the basis of the stock by the actual cost per share, however, if the taxpayer notifies the broker in writing. The taxpayer must notify the broker by the earlier of the date of the sale of any of the stock or one year after the date of the confirmation. A broker may extend the one-year period but no later than the date of sale.

3. Standing Orders

The Institute asked the IRS to clarify whether brokers are required to accept standing orders for identification of stock. The final regulations do not adopt this change, but the Preamble notes that the proposed regulations did not require taxpayers or brokers to use or accept standing orders.

4. Confirmation of Sales

The final regulations retain the existing requirement that brokers provide written confirmation of a taxpayer's specific identification of stock following a sale or transfer. In response to comments by the Institute and others, the final regulations do provide that account statements or other documents a broker or agent periodically provides to a taxpayer may serve as written confirmation if provided to the taxpayer within a reasonable time after the sale or transfer.

Broker Reporting

1. Form and Manner of Broker Reporting

Consistent with the rule for shareholder calculation of basis on multiple lots purchased on one day, the final regulations provide that a broker must report the basis of purchased stock and the gross proceeds of sold stock by averaging the basis or proceeds of each share, if the stock is purchased or sold at separate times on the same calendar day in executing a single trade order and the broker executing the trade provides a single confirmation to the taxpayer that reports an aggregate total price or an average price per share. A broker may not average the basis or proceeds, however, if the shareholder timely notifies the broker in writing of his intent to determine the basis or proceeds by the actual cost or proceeds per share.

2. Covered Securities

The proposed regulations defined "covered security" to include a specified security acquired through a sale transaction. In response to comments regarding what constitutes a sale transaction, the final regulations eliminate the sale-transaction rule and define "covered security" to include a specified security acquired for cash.

The final regulations also clarify that a security acquired by a foreign person that is exempt from Form 1099-B reporting at the time of the acquisition is not a covered security even if the customer later loses this exemption. This rule does not apply, however, if the broker knows or should have known that the customer is not a foreign person when the security is acquired.

3. Foreign Intermediaries

The proposed regulations included in the definition of "broker" non-U.S. payors and non-U.S. middlemen to the extent provided in a withholding agreement described in Treas. Reg. § 1.1441-1(e)(5)(iii) between a qualified intermediary and the IRS. In response to comments, the final regulations do not adopt this rule. Thus, a qualified intermediary that is not a U.S. payor or U.S. middleman as described in Treas. Reg. § 1.6049-5(c)(5) will not be treated as a broker with respect to sales effected at an office outside the United States. The government notes that the recently enacted provisions of chapter 4 of Subtitle A of the Internal Revenue Code (the Foreign Account Tax Compliance Act, or "FATCA") will impose certain information reporting requirements on foreign financial institutions that enter into an agreement with the IRS under section 1471(b). The Treasury Department and IRS intend to issue future guidance coordinating the reporting requirements under sections 6045 and 1471. The government also anticipates that, if a foreign financial institution has made an election under 1471(b) to report certain information required under sections 6041, 6042, 6045 and 6049, the agreement with the IRS would specify the extent of such person's reporting obligations with respect to information required to be reported under section 6045.

4. Determination of Basis and Long-Term/Short-Term Gain or Loss

The proposed regulations required brokers to adjust reported basis to reflect information received on a transfer statement or issuer return but otherwise did not require brokers to consider transactions, elections or events occurring outside the account. The Institute and others asked the IRS to clarify whether brokers must apply certain Internal Revenue Code provisions in determining adjusted basis.

In response to the Institute's request, the final regulations provide that brokers are not required to take into account the six-month conversion rules under sections 852(b)(4)(A)(capital gain dividends) and 852(b)(4)(B) (tax-exempt dividends) when reporting a shareholder's loss. The Preamble explains that the payment of tax-exempt dividends and the existence of capital gain dividends may or may not occur in the same account as the sale. Further, the Preamble notes that if the final regulations had required these adjustments, brokers would have had to include additional information on transfer statements about whether and when these types of dividends had been received or reported.

The Institute also asked the IRS to exercise its authority under section 852(b)(4)(E) to shorten the holding period for tax-exempt dividends under section 852(b)(4)(B) to 31 days. The IRS did not adopt this change because it is outside the scope of the regulations, but they may consider it for future guidance. [6]

The Institute suggested that the final regulations limit the application of the sales load basis deferral rule of section 852(f) to reinvestments that occur by January 31 of the year following the disposition of the load-paying shares. The final regulations do not adopt this suggestion; the RIC Modernization Act, if enacted, would amend the statute to provide this limitation.

5. Basis Determination Method

The final regulations require brokers to report basis using the basis determination method elected by the customer. Although some commentators requested that brokers be permitted to offer limited basis reporting methods, the final regulations do not adopt this request. The Preamble notes that section 1012 permits taxpayers to report basis by any permissible method, and section 6045 requires brokers to follow instructions from customers regarding this selection.

6. Customer Identification of Securities

Some commentators asked the IRS to clarify how to apply the first-in, first-out ("FIFO") reporting rule when the broker does not know the acquisition date of some shares within the account. The final regulations thus provide that brokers must report the sale of any shares of a security in an account with unknown acquisition dates first. Taxpayers are expected to report basis consistently with broker reporting.

7. Wash Sales

Section 6045(g) requires that, except as provided in regulations, a broker must apply the wash sale rules of section 1091 when reporting the adjusted basis of a covered security if the purchase and sale transactions resulting in a wash sale occur in the same account and are for identical securities. The final regulations clarify that brokers need not apply the wash sale rules when the purchase and sale are initiated in separate accounts but the purchased shares are later transferred into the account of the sold shares, because the purchase and sale transactions do not occur in the same account. Similarly, brokers need

not report a wash sale when the purchase and sale transactions occur in the same account but the purchased security is transferred out of the account prior to the wash sale. The final regulations also provide that the account limitation for wash sale reporting applies to stock treated as held in separate accounts. Thus, a broker is not required to report a wash sale involving a covered security and a noncovered security unless a single account election is in effect.

If a wash sale occurs after a broker has completed a return or statement reporting a sale of a covered security, the final regulations provide that the broker must redetermine whether gain or loss on the sale is long-term or short-term and correct the return or statement, if necessary, by the original due date for such return or statement.

Reporting to S Corporations

Brokers must begin reporting to S corporations under section 6045 for sales of covered securities beginning in 2012. For these sales, the proposed regulations eliminated the "eyeball test," which allowed brokers to rely solely upon the name of the customer to determine whether the customer is a corporation exempt from reporting. The IRS removed this rule because brokers generally cannot determine from a customer's name alone whether it is taxed as an S corporation or a C corporation. In response to comments, the final regulations retain a limited eyeball test for insurance companies and foreign corporations, because such entities are ineligible to elect S corporation status. The final regulations also retain current rules that allow brokers to determine that a customer is a foreign corporation by relying upon the name of the customer or upon a certification on a Form W-8.

February 15 Reporting Deadline

Section 6045(b) extended the due date to furnish Forms 1099-B to customers from January 31 to February 15. Section 6045(b) provides that this February 15 due date also applies to any other statement required to be furnished on or before January 31 of the same year if furnished in a consolidated reporting statement with a statement required under section 6045. The Institute asked the IRS to clarify that the February 15 deadline also applies to accounts in money market funds that are exempt from reporting under section 6045. The final regulations adopt this request and provide that a customer may be treated as receiving a required section 6045 statement under this rule even if the customer's account holds only cash or shares of money market funds.

Transfer Reporting

1. Scope

The proposed regulations required brokers to provide transfer statements for transfers of all securities, including securities or accounts otherwise exempted from all section 6045 reporting at the time of the transfer. Because such a rule was unnecessary, the Institute asked the IRS to eliminate this transfer reporting requirement for exempt securities. The final regulations adopt this recommendation and provide that brokers are not required to provide transfer statements for transfers of securities that are exempt from reporting under section 6045, including shares in nontaxable accounts and money market funds.

The Institute also asked the IRS to provide that a trustee or custodian of a nontaxable account is not required to provide a transfer statement when securities in the account are

distributed to the owner or an heir (an “in kind distribution”). The Preamble clarifies that securities held in individual retirement plans and other nontaxable accounts generally are treated as noncovered securities, and brokers are not required to report basis when shares are transferred from nontaxable accounts.

2. Information Furnished on a Transfer Statement

The proposed regulations required transfer statements to include information regarding the “beneficial owner” of securities. In response to comments, the final regulations refer to “customer” instead of “beneficial owner.”

The final regulations also clarify that a transfer statement for noncovered securities need not identify the securities at the lot level; rather, a single transfer statement may be used to report the transfer of multiple noncovered securities.

The proposed regulations required brokers to include on transfer statements several pieces of information regarding the customer and the shares being transferred. The Institute and others commented that much of this information was unnecessary and, in some cases, could create privacy concerns. The final regulations adopt these recommendations and provide that a transfer statement need not include the customer’s taxpayer identification number, address or phone number; the security symbol or lot number of the transferred security; or the date of any previous transfer statement. The transfer must include the customer’s name and account number, but this information may be reported in a coded format.

Thus, under the final regulations, a transfer statement must include: (i) the date the statement is furnished; (ii) the name, address and telephone number of the applicable person furnishing the statement; (iii) the name, address and telephone number of the broker receiving custody of the security; (iv) the name and account number of the customer(s) for the account from which the security is transferred and, if different, the name and account number of the customer(s) for the account to which the security is transferred; (v) the Committee on Uniform Security Identification Procedures (CUSIP) number of the security transferred; (vi)the date the transfer was initiated and the settlement date of the transfer (if known), and (vii) the total adjusted basis of the security, the original acquisition date of the security, and, if applicable, any holding period adjustment required due to a wash sale. [7] As provided in the proposed regulations, the person furnishing the transfer statement and the receiving broker may agree to combine this information in any format or to use a code in place of one or more required items.

The final regulations clarify that noncovered securities that are subject to a single account election, thus becoming covered securities, remain covered securities after a transfer, provided the receiving broker receives a transfer statement.

3. Gifted and Inherited Securities

The proposed regulations provided that gifted and inherited securities that were covered securities in the account of the donor or decedent remained covered securities when transferred to the recipient’s account and accompanied by a transfer statement. The Institute and others asked the IRS to provide simplified default rules for these types of transfers, because the proposed rules were complicated and raised a number of implementation issues, the burden of which outweighed the benefit of any information provided.

The IRS adopted the Institute’s recommendation with respect to inherited securities. Thus,

under the final regulations, a transferor must report adjusted basis equal to the fair market value of the security on the date of death, unless the broker receives different instructions from the estate representative. If the transferor cannot identify which securities in a joint account have been transferred from the decedent, the final regulations require the transferor to treat each security in the account as if it were a noncovered security. The final regulations also require transfer statements for both initial and subsequent transfers of an inherited security to indicate that the security is inherited. This rule was added, at the request of the Institute, [8] to provide information needed by subsequent brokers to apply the holding period rules for property acquired from a decedent that is sold or disposed of within one year after the decedent's death.

The IRS did not adopt the recommendations by the Institute and others with respect to gifted securities. Thus, the rules for transfers of gifted shares in the proposed regulations are retained in the final regulations.

4. Other Transfer Reporting Issues

The final regulations clarify that a transfer statement is complete if, in the view of the receiving broker, it provides sufficient information to report the sale of the transferred security as a covered security, or states that the security is a noncovered security. The final regulations also provide that transfer statements for covered securities must reflect the quantitative effect of any organizational actions on basis reported under section 6045B while the transferor holds custody, instead of identifying which corporate action statements are reflected on the transfer statement.

Reporting by Issuers of Actions Affecting Basis of Securities

Section 6045B provides that, if an organizational action by an issuer affects the basis of a specified security, the issuer must file a return with the IRS and furnish an information statement to each certificate holder or nominee reporting the quantitative effect on basis. As requested by several commentators, the final regulations eliminate the proposed requirement that the issuer assign a sequential number for each organizational action reported. The purpose of this proposed rule was to indicate which basis adjustments for organizational actions were reflected on the transfer statement. Instead, the final regulations require transfer statements to reflect all organizational actions that occur while the transferor holds custody.

The Institute asked the IRS to provide a safe harbor for RICs to the extent that they participate in the Institute's year-end tax reporting spreadsheet process. The final regulations do not adopt this recommendation. Thus, RICs (except for money market funds) must comply with the issuer reporting requirements under section 6045B. The final regulations do provide that a RIC or real estate investment trust ("REIT") that files and furnishes Form 2438, "Undistributed Capital Gain Tax Return," and Form 2439, "Notice to Shareholder of Undistributed Long-Term Capital Gains," is deemed to meet the requirements under section 6045B for undistributed capital gains affecting the basis of its stock reported on the forms. RICs and brokers holding custody of RIC and REIT stock must adjust basis in accordance with the information reported on the forms.

The final regulations provide that an issuer must amend previous reporting under section 6045B whenever the issuer determines additional facts that result in a different quantitative effect on basis from that which was previously reported.

Section 6045B waives the requirements to file issuer returns and furnish issuer statements if the issuer makes the information publicly available in the form and manner determined by the IRS. The final regulations adopt the rules in the proposed regulations that permit an issuer to publicly report organizational actions affecting basis by posting a statement with the required information in a readily accessible format in an area of the issuer's primary public web site. This information must be posted by the same due date for reporting to the IRS and must remain accessible to the public. Upon the request of the Institute and others, the final regulations limit the required period for which such information must remain posted on the public web site to ten years.

Penalty Provisions

The final regulations adopt the penalty provisions contained in the proposed regulations. Although the final regulations do not provide any transition relief, the Preamble states that the IRS will continue to work closely with brokers to ensure the smooth implementation of the cost basis reporting requirements, including the mitigation of penalties in the early stages of implementation for all but particularly egregious cases.

The final regulations do adopt recommendations by the Institute and others that the rules provide time limits on the requirement that brokers and transferors must correct Forms 1099-B or transfer statements to account for late or corrected transfer statements or issuer reports. Thus, the final regulations require corrected reporting only when brokers receive corrected information within three years after issuing a Form 1099-B or eighteen months after issuing a transfer statement.

Effective Dates

The cost basis reporting requirements become effective with respect to stock, other than shares in RICs or DRiPs acquired on or after January 1, 2011. The reporting requirements apply to shares in RICs and DRiPs acquired on or after January 1, 2012. The final regulations do not delay these statutory effective dates. To assist industry compliance efforts, however, the IRS issued a separate notice that provides transitional relief from the transfer reporting requirements under section 6045A for 2011 only. [9] This transitional relief does not apply to transfers of RIC shares because the transfer reporting requirements are not effective for RIC shares until 2012.

The final regulations on broker basis reporting under section 6045(g) apply to any share of RIC stock or DRiP stock acquired on or after January 1, 2012; they apply to all other stock in an entity organized, or treated for Federal tax purposes, as a corporation acquired on or after January 1, 2011.

The regulations regarding a taxpayer's determination of basis under section 1012 generally apply for taxable years beginning after October 18, 2010. The rules regarding average cost, however, generally apply to stock acquired on or after January 1, 2012.

The regulations regarding transfer statement reporting under section 6045A apply to transfers of RIC stock on or after January 1, 2012; they apply to transfers of other stock on or after January 1, 2011.

The regulations regarding issuer reporting under section 6045B apply to organizational actions affecting basis of RIC stock on or after January 1, 2012; they apply to organizational

actions for other stock on or after January 1, 2011.

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endnotes

[1] See Institute Memorandum (24606) to Broker/Dealer Advisory Committee No. 42-10, Bank, Trust and Recordkeeper Advisory Committee No. 35-10, Tax Members No. 30-10, Operations Members No. 12-10, Transfer Agent Advisory Committee No. 59-10, and Small Funds Members no. 58-10, dated October 13, 2010.

[2] For copies of the Institute's comment letters on the proposed regulations, see Institute Memorandum (24133) to Broker/Dealer Advisory Committee No. 6-10, Bank, Trust and Recordkeeper Advisory Committee No. 5-10, Operations Members No. 1-10, Small Funds Members No. 11-10, Tax Members No. 4-10, and Transfer Agent Advisory Committee No. 9-10, dated February 12, 2010; and Institute Memorandum (24322) to Broker/Dealer Advisory Committee No. 15-10, Bank, Trust and Recordkeeper Advisory Committee No. 12010, Operations Members No. 6-10, Small Funds Members No. 34-10, Tax Members No. 15-10, and Transfer Agent Advisory Committee No. 26-10, dated May 25, 2010.

[3] For pre-effective date shares, a change from average cost to another method applies to all identical stock in any account. For post-effective date shares, the change applies on an account-by-account basis.

[4] The revocation period is the earlier of one year or the date of the first sale, transfer or disposition from the account. Brokers may extend the revocation period but not beyond the date of the first sale, transfer or disposition.

[5] Treas. Reg. § 1.1012-1(e)(5)(ii).

[6] The Regulated Investment Company Modernization Act of 2010 (the "RIC Modernization Act"), which passed the House of Representatives on September 28, 2010 (H.R. 4337), would amend section 852(b)(4)(B) to simplify application of the loss disallowance rule for municipal bond funds. Specifically, the amendment would provide that the loss disallowance rule does not apply with respect to a regular dividend paid by a RIC that declares exempt-interest dividends on a daily basis in an amount equal to at least 90 percent of its net tax-exempt interest and distributes the dividends on a monthly or more frequent basis. See Institute Memorandum (24570) to Tax Members No. 29-10, dated October 1, 2010.

[7] If the basis of the transferred security is determined using average cost, the transferor may report any securities acquired more than five years before the transfer on a single statement on which the original acquisition date is reported as "various." The IRS retained this five-year rule because beginning in 2011, absent a statutory change, securities held for more than five years may be subject to a lower capital gains rate.

[8] See Institute Memorandum (24417) to Tax Members No. 18-10, Operations Members No. 7-10, Broker/Dealer Advisory Committee No. 26-10, transfer Agent Advisory Committee No. 34-10, and Bank, Trust and Recordkeeper Advisory Committee No. 19-10, dated July 14, 2010.

[9] See Institute Memorandum (24606), infra.
