MEMO# 24877

January 14, 2011

ICI Letter to IRS and Treasury on Average Cost as Default Method

[24877]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 5-11
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 5-11
TAX MEMBERS No. 2-11
OPERATIONS MEMBERS No. 2-11
TRANSFER AGENT ADVISORY COMMITTEE No. 5-11
SMALL FUNDS MEMBERS No. 5-11 RE: ICI LETTER TO IRS AND TREASURY ON AVERAGE COST AS DEFAULT METHOD

The Institute submitted the attached letter to the Internal Revenue Service and the Treasury Department urging them to amend a broker-default rule in the final cost basis reporting regulations that is highly detrimental to mutual fund shareholders. This provision was not included in the proposed regulations; consequently, the mutual fund industry, which is most affected by the rule, had no opportunity to comment on it. Because the default method decision is a cornerstone of the cost basis reporting implementation process, it is essential that the IRS and Treasury promptly announce their intentions regarding this issue.

Under the default rule provided by the final regulations, a customer who holds shares in an account for which the broker's or fund's default method is average cost must elect a basis method immediately upon opening a new account or upon acquiring new covered shares in an existing account. If the customer fails to make such an election, the customer may change methods prospectively only, even if no redemptions have occurred. This provision thus eliminates a taxpayer's opportunity, when he redeems shares, to choose which basis method to use and, consequently, which shares to redeem. [1] This rule is detrimental to shareholders and directly contradicts other provisions of the regulations. The rule also makes it far less likely that brokers and funds will choose average cost as their default method.

Amending this default rule is of the utmost importance to the Institute and its members. The letter urges the IRS and Treasury Department to announce promptly that brokers and funds that choose average cost as their default method may allow their customers to select any other basis method for existing shares until the time of the first redemption from that account.

Karen Lau Gibian
Associate Counsel

Attachment

endnotes

[1] For example, assume a taxpayer purchases 100 shares in Fund A in 2012 for $10 per share. The broker's default method is average cost, and the shareholder does not affirmatively elect a method at that time. In 2013, the taxpayer buys an additional 100 shares in Fund A for $15 per share. In 2014, the taxpayer informs his broker that he wishes to sell 50 of the shares purchased in 2013 at $15 per share. Under this rule, however, the broker must use the average cost method, selling 50 shares at $12.50 per share.
