

**MEMO# 25294**

June 22, 2011

# **IRS Issues Guidance on Average Cost Default Method, Other Cost Basis Reporting Issues**

[25294]

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TO: BDAC COST BASIS REPORTING TASK FORCE No. 15-11  
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 36-11  
BROKER/DEALER ADVISORY COMMITTEE No. 37-11  
OPERATIONS MEMBERS No. 13-11  
SMALL FUNDS MEMBERS No. 44-11  
TAX MEMBERS No. 19-11  
TRANSFER AGENT ADVISORY COMMITTEE No. 48-11 RE: IRS ISSUES GUIDANCE ON  
AVERAGE COST DEFAULT METHOD, OTHER COST BASIS REPORTING ISSUES

We are pleased to report that the Internal Revenue Service (the “IRS”) has issued Notice 2011-56 [\[1\]](#), which provides interim guidance on certain issues relating to cost basis reporting for stock. Specifically, as requested by the Institute, [\[2\]](#) the notice provides shareholders with the flexibility to choose a different basis reporting method when the broker chooses average cost as its default. The notice also addresses issues related to dividend reinvestment plans (“DRPs”) and lot selection methods across accounts. The notice states that the IRS and Treasury Department intend to release additional proposed regulations addressing these and other issues raised by stakeholders; until such regulations are published, taxpayers may rely upon the guidance provided in this notice.

## **Change from Broker Default Average Basis Method**

The final cost basis regulations [\[3\]](#) provide that, if a broker chooses average cost as its default method, a shareholder may change from that method prospectively only. In effect, this rule requires a shareholder to affirmatively elect a basis method (i) immediately upon opening a new account, for accounts opened on or after January 1, 2012, or (ii) on or before the purchase of new fund shares in an existing account. If the shareholder fails to immediately elect another method, and the broker’s default is average cost, the final

regulations require the broker to use the average cost method for any shares acquired in the account until the shareholder chooses another method. If the shareholder later chooses another method, the newly elected method will apply only to shares subsequently acquired.

The Institute argued that such a rule is detrimental to shareholders, because it significantly reduces their ability to choose basis methods; This rule also plainly contradicts other provisions in the regulations, which permit a taxpayer to specifically identify stock to be sold at the time of sale. Finally, the Institute noted that the average cost default rule will severely limit brokers' and mutual funds' ability to use average cost as a default method because it makes average cost more onerous than other methods, from a customer-servicing standpoint. For these reasons, the Institute urged the IRS and Treasury Department to permit shareholders to choose any basis method up until the date of the first redemption, regardless of the broker's default method.

In response to our request, Notice 2011-56 states that the proposed regulations are expected to provide that, when a taxpayer changes from a broker's default method of average cost, the basis of the stock will revert to the individual cost basis for each lot if the taxpayer requests the change by the earlier of (1) one year after receiving notice of the broker's default method, or (2) the date of the first sale, transfer, or other disposition of the stock. A broker may extend the one-year period, but not later than the date of the first sale, transfer, or disposition of the stock. This change will make the average cost default rule consist with the rule for revoking a taxpayer's average cost election.

Thus, pursuant to this change, a shareholder is not locked into the broker's default of average cost if the shareholder notifies the broker that he or she wishes to use a different method, and such request is made by the earlier of one year (or longer, if the broker chooses) or the first redemption. [\[4\]](#)

To determine the beginning of the one-year period, a broker using the average basis method as a default method must use reasonable means to notify taxpayers of its default method. Reasonable means may include mailings, circulars, or electronic mail sent separately or included in a taxpayer's account statement, or other means reasonably calculated to provide actual notice. The notice must identify the securities subject to the broker's default average cost method.

## **DRPs - Ten Percent Reinvestment Rule and Fractional Shares**

The final regulations provide that certain DRPs may use the average cost method. To qualify for average cost, the DRPs' written plan documents must require that at least 10 percent of every dividend on any share of stock is reinvested in identical stock. The IRS subsequently was asked if a plan that pays only cash in lieu of fractional shares meets the 10 percent requirement if the dividends on some shareholders' stock are insufficient to acquire at least one whole share of identical stock. The IRS expects the proposed regulations to clarify that a DRP does not fail the 10 percent reinvestment requirement because it pays cash in lieu of fractional shares when the amount of a dividend is insufficient for some shareholders to acquire stock.

# Lot Selection Methods across Accounts

The final cost basis reporting regulations provide that average cost is to be applied on an account-by-account basis [5] but do not address other basis methods, such as first-in, first-out (“FIFO”) and specific identification, even though the statute provides that any basis reporting “conventions” prescribed in the regulations apply on an account-by-account basis (for stock acquired on or after the effective dates). [6] The notice thus provides that the proposed regulations are expected to clarify that lot selection methods, such as FIFO and specific identification, apply on an account-by-account basis.

Karen Lau Gibian  
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## endnotes

[1] The Notice can be found on the IRS’s website at <http://www.irs.gov/pub/irs-drop/n-11-56.pdf>.

[2] See Institute [Memorandum](#) (24877) 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, and Small Funds Members No. 5-11, dated January 14, 2011.

[3] The IRS and Treasury Department expect to revise the final regulations to reflect the guidance in this notice. Until additional guidance is issued, taxpayers may rely upon the rules in Notice 2011-56, rather than those in the final regulations.

[4] The notice does not specifically address this, but presumably the proposed regulations will require this request to be made in writing, as is required when a shareholder wishes to change from an affirmative average cost election to another method.

[5] Treas. Reg. § 1.1012-1(e).

[6] See section 1012(c)(1).

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