The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24133

February 12, 2010

Institute Comment Letter on Proposed Cost Basis Reporting Regulations

[24133]

February 12, 2010

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
TRANSFER AGENT ADVISORY COMMITTEE No. 9-10 RE: INSTITUTE COMMENT LETTER ON PROPOSED COST BASIS REPORTING REGULATIONS

The Institute submitted the attached letter to the Internal Revenue Service ("IRS") and the Treasury Department regarding the recently released proposed regulations on cost basis reporting. The Institute also submitted the attached outline of issues that we wish to discuss at the public hearing on the proposed regulations, scheduled for February 17, 2010.

The Institute's comment letter commends the IRS for drafting proposed rules that incorporated many of our recommendations [1] and for addressing many of the relevant issues with rules that are logical and workable. We note, however, that there remain some areas where calculation and reporting issues persist and where further clarification is needed from the government. The Institute notes that, among the various issues discussed in our comment letter, the most pressing concerns for the mutual fund industry are:

- Average Cost. The Institute believes that the IRS should eliminate the requirement that average cost elections be made in writing. We also feel that shareholders should be permitted to switch easily from average cost to another method.
- Gifted and Inherited Shares. The Institute strongly feels that Congress did not intend

for these shares to be covered by the basis reporting rules. If the IRS insists that they are covered, the default rules in the proposed regulations must be made more administrable.
- lexibility for Transfer Statements. Brokers should have maximum flexibility with respect to transfer statements, including the information required on such statements.
- February 15 Reporting Deadline. The extended deadline should apply, as Congress intended, to any form that brokers send to mutual fund shareholders.

The Institute also urges the IRS and Treasury Department to issue final regulations on these issues quickly, given the short time frame before the cost basis reporting requirements become effective.

I. Form and Manner of Reporting Requirements

A. Draft Form 1099

The Institute commends the IRS for releasing a draft Form 1099-B for public comment, along with the proposed regulations, but asks that the government also release a draft Schedule D. This would allow the industry to see how their shareholders will use and report the information on the Form 1099-B, which in turn would better inform us as to how such information should be reported by brokers. We note that the Schedule D should include some way for a shareholder to indicate that the basis numbers he or she is using differ from those provided by the broker, for those situations in which the shareholder has applied a basis adjustment rule that the broker is not required to apply (e.g., for wash sales occurring outside an account).

The Institute also asks for clarification regarding brokers' responsibility with respect to reporting gain or loss on the Form 1099-B. Although section 6045(g) and the proposed regulations only require brokers to report whether a taxpayer's gain or loss is short-term or long-term, the draft Form 1099-B requires brokers to report the amount of the taxpayer's gain or loss (in box 7). It is not clear, however, which rules brokers must take into account when reporting the holding period and amount of gain or loss. Although there are a number of provisions which could affect these items, the Institute asks specifically for clarification with respect to:

- Wash Sales. The proposed regulations do not specify whether brokers must adjust the amount of gain or loss reported on the Form 1099-B for any loss disallowed due to a wash sale. The Schedule D also must state clearly whether taxpayers should adjust their gain or loss for the amount of disallowed loss reported on the Form 1099-B.
- Six-Month Conversion Rules. The proposed regulations also do not specify whether brokers should take into account the six-month conversion rules in section 852(b)(4) when reporting gain or loss on the Form 1099-B. [2] We ask the IRS to clarify brokers' responsibility with respect to these rules. The Institute also asks the IRS to exercise its regulatory authority under section 852(b)(4)(E) to shorten the required holding period with respect to tax-exempt dividends in section 852(b)(4)(B) from six months to 31 days. We note that the current rule makes no sense for tax-exempt bond funds that declare dividends daily and pay monthly. Because the net amount of tax-exempt interest received by a daily declaration fund is declared as a dividend each day, that

income is not includible in the fund's net asset value ("NAV"). Therefore, any decline in the NAV is attributable to a real economic loss and not to a periodic payment of a dividend. Regulations that decrease the holding period to 31 days will reduce significantly the number of loss conversions that occur and will limit brokers' requirement to track the holding period of individual lots, if the IRS determines that brokers must take the six-month conversion rules into account for reporting purposes.

B. Corrected Forms 1099

The Institute recommended in its 2009 comment letter that the IRS provide a de minimis rule for amended Forms 1099 as well as a cut-off date after which such amendments need not be made. The IRS did not take these suggestions. Given the increased amount of information that must be reported on Form 1099-B, resulting in a significant increase in the number of corrected Forms 1099-B, the Institute reiterates its recommendation that the IRS provide a de minimis rule, pursuant to which a broker does not have to amend a customer's Form 1099 if the aggregate adjustment from the income initially reported (or the basis, in the case of gross proceeds reporting) is $10 or less. The Institute also recommends that the IRS provide a cut-off date for amending tax information from prior calendar years (an exception could be made for substantial errors). At the very least, we ask the IRS to confirm that brokers need not send corrections for returns filed more than three years prior (four years for payments subject to backup withholding), as specified in Rev. Proc. 2009-30.

II. Calculation of Basis

A. Selection of Basis Method and Broker Default Methods

The Institute asks for clarification on several points related to shareholders' basis method selection and broker default methods. First, we ask the IRS to amend the proposed regulations to provide expressly that any agent of the taxpayer is permitted to choose a basis method or identify specific lots on behalf of the taxpayer. Second, we ask the IRS to clarify that brokers are not required to accept standing orders but may do so at their discretion. We also ask the IRS to eliminate the current rule (which was not changed by the proposed regulations) requiring written confirmation of the sale of stock that a taxpayer has specifically identified, as recommended in our 2009 comment letter. If the IRS insists that this requirement remain in place, we ask that the regulations not require brokers to send written confirmations for standing orders. Finally, the Institute notes that the proposed regulations, as currently written, seem to preclude brokers from choosing a default method other than first in, first out ("FIFO"). We do not believe that this was intentional and ask the IRS to clarify that brokers may choose any default method with respect to RIC shares, as the statute provides.

B. Definition of Account

The proposed regulations do not define the term "account" for purposes of the basis reporting rules, and the Institute supports this position. The mutual fund industry believes

the statute and the proposed regulations achieve the intended result and provide sufficient information for us to determine how to apply the cost basis reporting rules. We understand, however, that others may encourage the IRS to define an account for their unique purposes, and although the IRS should provide clarification when needed, we ask the IRS to refrain from defining accounts generally.

C. Adjustments for Transactions Occurring Inside the Account

1. Wash Sales

As recommended in our 2009 comment letter, the Institute reiterates our suggestion that the IRS adopt a de minimis exception to the wash sale rule of section 1091. Without such an exception, brokers may need to send amended Forms 1099 if such forms are sent to shareholders before brokers are able to perform their wash sale runs. Therefore, we ask the IRS to give brokers the option not to apply the wash sale rule to correct Forms 1099 for loss disallowances of $10 or less arising from share purchases occurring after December 31 that affect the cost basis of shares sold before January 1 (and within 30 days of the purchase).

2. Sales Load Basis Deferral Rule

The proposed regulations provide, in an example, that if a shareholder buys and then sells shares in one account, followed by the purchase of shares in another account pursuant to a reinvestment right, then the broker is not required to apply the sales load basis deferral rule of section 852(f) for reporting purposes. It is not clear, however, when a shareholder is treated as exercising a reinvestment right in a separate account. The Institute thus asks the IRS to clarify that brokers are not required to apply section 852(f) in circumstances where a shareholder exercises the reinvestment right with respect to securities with a different Committee on Uniform Security Identification Procedures ("CUSIP") number. We also ask for clarification as to whether a broker must apply the sales load basis deferral rule in situations where a shareholder purchases shares in Fund A, then sells those shares within 90 days and purchases shares in a money market fund (for which no sales charge is imposed); several years thereafter, the shareholder redeems the money market fund shares and reinvests in Fund A without incurring an additional sales charge. This transaction clearly is not the type for which the sales load basis deferral rule was crafted. Nevertheless, it is not clear under the proposed regulations whether brokers must retroactively recalculate the gain or loss on the original Fund A shares.

We note that the RIC Modernization Act of 2009 (H.R. 4337) provides a solution to this issue. The bill limits the rule's application to cases in which a taxpayer makes a reinvestment triggering the rule by January 31 of the calendar year following the year in which the redemption of the initial investment occurred.

This change will reduce the likelihood that a broker will have to send an amended Form 1099-B because of the sales load basis deferral rule. If the RIC Modernization Act is not enacted, however, we reiterate our recommendation in our 2009 comment letter that the IRS issue guidance providing that this limited rule will apply to brokers for basis reporting purposes.

D. Elimination of Double-Category Average Cost Method

The proposed regulations eliminate the double-category average cost method, as the Institute suggested in our original comment letter. We reiterate our support for this change.

E. Average Cost

1. Shareholder Election

The Institute asks the IRS to eliminate the rule contained in the proposed regulations that requires a taxpayer to make an average cost election, for post-effective date shares, in writing. The mutual fund industry believes that this rule is impracticable and creates a number of customer service issues, both for existing and new customers. Rather, the industry would prefer to have maximum flexibility, as with other basis method selections, when determining how to communicate with their shareholders.

Further, it is not clear how the writing requirement interacts with the broker default method. Brokers have the ability to choose any default method with respect to RIC shares. If the shareholder must elect average cost in writing, however, it does not appear that a broker could use average cost as its default method. We do not believe this was Congress' intent.

If the IRS insists that the average cost election be made in writing, the Institute asks that the IRS clarify that an electronic notification qualifies as such for this purpose. We also ask that the proposed regulations permit brokers to assume negative consent from shareholders if average cost is the broker's default method. Finally, shareholders should be permitted to make a single written election that applies to all accounts with that broker, including accounts opened in the future, unless the shareholder specifically chooses a different method for each account.

2. Revocation of Election

The Institute recommends that, if the IRS eliminates the requirement that

taxpayers must elect average cost in writing, that the revocation period begin when either the taxpayer makes an affirmative average cost election or the broker notifies the taxpayer that the broker's default basis method is average cost. The Institute also asks for some leniency in the first few years following the effective date for RIC shares, as there may be a higher number of corrections to information statements in the early years.

3. Change from Average Cost Method

As originally suggested in our 2009 comment letter, the Institute asks the IRS to eliminate the requirement that taxpayers seek the Commissioner's consent before switching from the average cost method to another method. The industry feels strongly that shareholders should be permitted to switch easily from average cost to another method, and requiring the government's consent is unnecessary, particularly because shareholders can switch methods simply by opening a new account. Requiring consent from the Commissioner may discourage many brokers from using average cost as their default method, as it effectively would lock shareholders into average cost for the life of the account.

If the IRS believes that a change from average cost should be treated as a change in method of accounting, as provided in the proposed regulations, the Institute asks that the IRS grant broad consent permitting taxpayers to make this change, to make the process as simple as possible.

Also, if a change from average cost is a change in method of accounting, we ask the IRS to provide that taxpayers have an obligation to inform their broker, through any reasonable means, that they are changing from average cost to another method. Brokers only should be required to retain and report basis information using a method other than average cost after it receives such notification, and then only for any shares acquired after such notification.

4. Single Account Election

The Institute asks for clarification on several points relating to the single account election. First, we note that it is not clear how the broker election to use a single account interacts with the shareholder's average cost election. The proposed regulations provide that the single account election is irrevocable, but the proposed regulations also provide that taxpayers may revoke or change their average cost election, or they may choose another method if the shares are transferred to another broker. In such cases, the IRS should provide that the pre-effective date shares remain "covered" because of the single account election, with a basis equal to the average cost of the account before the revocation or method change.

The Institute also asks the IRS to eliminate the accuracy requirement for the single account election. The proposed regulations provide that brokers may make the election only if the basis information for the pre-effective date shares is "accurate;" such information is accurate if the broker neither knows nor has reason to know that such information is inaccurate. It is not clear that funds will feel confident that their data meets this standard, for a number of reasons. As a result, many funds may be reluctant to use the single account election. Therefore, the IRS should allow funds in all cases to use data for pre-effective date shares.

Finally, we ask the IRS to clarify that brokers may, at their discretion, use shareholder-provider information for pre-effective date shares for purposes of the single-account election. There may be situations in which a shareholder has basis information for such shares but the broker does not; as a customer service, the broker may wish to make the single account election at the shareholder's request. Brokers should be permitted to use shareholder-provided information, with appropriate penalty relief.

F. Dividend Reinvestment Plans

In general, the Institute does not have any comments on the proposed regulations regarding dividend reinvestment plans ("DRIPs"); our understanding is that these rules do not apply to RIC shares because RICs already are able to use average cost. To be clear, however, we do ask the IRS to amend the definition of DRIPs in the proposed regulation to specify that it does not apply to dividends reinvested in a RIC. Also, to the extent that further clarification to the average cost or other rules are needed to address DRIP-specific issues, we ask that the IRS limit those rules to DRIPs, rather than applying them broadly to any shares for which average cost is available.

III. Reporting to S Corporations

The preamble to the proposed regulations indicates that the IRS is considering changes to the Form W-9 in connection with the new rule that S corporations are no longer exempt recipients for purposes of section 6045. As requested in our 2009 comment letter, we urge the IRS to promptly amend Form W-9 to provide an additional box where a shareholder can identify itself as an S corporation. We also ask the IRS to clarify whether S corporations are now subject to backup withholding with respect to gross proceeds.

IV. February 15 Reporting Deadline

The Institute strongly urges the IRS to modify the definition of "consolidated reporting statement" for purposes of the February 15 reporting deadline in the proposed regulations so that the extended deadline applies to all tax information statements sent by funds and brokers to their clients. Although the definition in the proposed regulations is more expansive than previous guidance, it applies only to information sent to shareholders who otherwise might receive a Form 1099-B (even if there are no sales or redemptions that year for which a Form 1099-B is sent). Thus, under the proposed regulations, brokers still must send information returns to shareholders who only have non-taxable accounts or money

market funds by January 31. Because brokers cannot distinguish easily these clients from others with taxable accounts, brokers effectively will be required to continue sending all information statements by January 31. This negates the purpose of the reporting deadline extension and is contrary to Congressional intent. Therefore, the Institute asks that the final regulations define a consolidated reporting statement to include all tax information sent by funds and brokers to their customers. Our recommendation would include statements sent to taxpayers who have investments held in Health Savings Accounts (which are reportable on Forms 1099-SA and 5498-SA).

We also ask that, for purposes of the February 15 reporting deadline, the proposed regulations refer to a "reporting entity" rather than a "broker." Notice 2010-9 uses the term "reporting entity," which is broader than the term used in the proposed regulations. We are concerned that the term "broker" may not encompass all parties which may be responsible for information reporting.

V. Transfer Reporting

In general, the Institute agrees with the proposed regulations as they apply to transfers of covered securities and believe these rules are workable, for the most part. In particular, we appreciate that the IRS has left many of the decisions regarding form and format to be made by the Industry. We note, however, that there are many different types of transfers that may be covered by the new reporting requirement, and the industry has not yet vetted fully (or even contemplated all of them). We may have additional comments on transfer reporting as we continue to consider these issues.

The Institute does have some concerns with respect to transfers of shares held by exempt recipients, some of the information required on the transfer statements, and gifted and inherited shares.

A. Transfer Statements for Exempt Recipients

The proposed regulations require brokers to send transfer statements for transfers of shares held by exempt recipients, even though those accounts are not subject to information reporting under section 6045. The Institute asks the IRS to amend this rule so that transfer statements are not required for securities held by shareholders exempt from reporting under section 6045. We explain that transfer statements for these accounts is superfluous and unnecessarily burdensome, as the information currently transferred with such securities indicates that tax reporting is not needed for those shares. Thus, there is no need for a separate transfer statement indicating that gross proceeds and cost basis reporting is not required.

B. Information Required

In general, the Institute believes that the information required by the proposed regulations to be included on a transfer statement is sufficient for both parties to the transaction to

properly identify the securities transferred and the adjusted cost basis. We appreciate that the proposed regulations permit the transferring and receiving brokers to agree to combine the information in any format, including the use of codes to represent certain information.

The Institute does have a few comments regarding the information required. First, we do not believe that a transfer statement should include the date of any previous transfer statement with respect to the same transfer, as required in the proposed regulations. We do not believe that this information will provide any benefit to the receiving broker and thus is unnecessary. Instead, we ask that the regulations simply require the transfer statement to include information that is sufficient to permit the receiving broker to identify the lots to which the transfer statement applies.

Second, the Institute has concerns regarding the requirement that the transfer statement include the name, address, telephone number, taxpayer identification number, and account number of the beneficial owner or owners both before and after the transfer. We are worried that including such information could lead to identify theft. Again, we ask the IRS to require only that the transfer statement include information sufficient to identify the beneficial owner or owners, and the industry will determine which information is necessary for this purpose.

Third, we note that lot numbers are not relevant for transfers of RIC shares, and this piece of information should be stricken from the proposed regulations, at least with respect to RIC shares.

Finally, we ask that, should the qualified five-year gain rules not come back into effect in 2011, the IRS amend the rule in the proposed regulations regarding the acquisition dates for shares for which average cost has been used. Specifically, we ask that such shares that have been held for more than one year, rather than shares held for more than five years, may be reported on a single transfer statement with the original acquisition date noted as "various."

C. Gifted and Inherited Shares

The Institute was disconcerted to learn that the IRS believes that gifted and inherited shares are covered securities. Based on our correspondence with Congressional leaders and our extensive discussions with Congressional staff, we believe Congress intended to exclude such securities from the cost basis reporting regulations. We point out that our understanding of Congressional intent was not contradicted by the IRS or Treasury Department during numerous discussions of our 2009 comment letter. Therefore, we ask the IRS to reconsider their stance on these types of transfers.

If the IRS firmly believes that such shares should be covered, then the rules regarding these types of transfers must be revised to provide rules that truly are workable for the industry

without being overly burdensome. We note that the rules for gifted and inherited shares in the proposed regulations present a number of issues for mutual funds. Therefore, we recommend simple default rules that easily could be applied. As suggested in our 2009 comment letter, the general rule should provide a default rule that carries over the cost basis of the transferred shares. Thus, a broker should assume that a transfer from one beneficial owner to another is a gift unless told otherwise. The default rule also should provide that the holding period for gifts is carried over from that of the donor. If the broker knows that the shares have been inherited (e.g., the broker receives a death certificate), the default rule should be a full stepped-up basis 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. The holding period for all inherited shares would be long term. In all cases, the broker should be permitted to override the default rules if the shareholder provides cost basis information.

Because we did not expect gifted and inherited shares to be treated as covered securities, the Institute and the industry has not had adequate time to fully vet all of the issues that may arise with information reporting on these types of securities. Therefore, we will continue to consider these issues and provide additional comments over the next few weeks.

We also ask the IRS to provide substantial transition relief with respect to gifted and inherited shares. Given the relatively short time frame before these rules become effective, brokers do not have sufficient time to program their systems to account for and understand all of the gift and inheritance basis adjustment rules. The timeline is compounded by the fact that Congress has not yet resolved the estate tax issue, and it is unclear what the rules will be after 2010.

VI. Corporate Action Reporting

The Institute believes that, with respect to RIC shares, information on corporate actions that can affect basis currently is being provided on a timely basis. For shares held directly on a fund's books, the fund itself will adjust shareholders' basis. For those shares held through a broker/dealer, we believe the year-end tax reporting spreadsheet that has been utilized by the mutual fund industry for two decades adequately notifies the relevant parties of any effect a mutual fund corporate action may have on RIC shares. Therefore, the procedures set forth in the proposed regulations are unnecessary. We thus ask the IRS to set forth a safe harbor, whereby RICs that provide information to brokers through the year-end tax reporting spreadsheet process are deemed to have complied with the corporate action reporting requirements in the proposed regulations.

If mutual funds are required to comply with these requirements as issuers of securities, we ask the IRS not to require RICs to issue identifying numbers with respect to returns of capital.

As holders of corporate securities in their portfolios, the mutual fund industry is concerned

about the ability of issuers to post the required information on their websites rather than sending such information to shareholders. It is not clear how often shareholders are expected to check issuer websites for information affecting basis. This requirement, which places the onus on the shareholder, is overly burdensome. We understand that the Securities Industry and Financial Markets Association ("SIFMA") is recommending that issuers furnish such information to each clearing organization (as defined in the regulations under section 163); the Institute supports this recommendation.

If issuers are permitted to post corporate action information on their websites, the proposed regulations should require them to keep such information online for at least one year. The proposed regulations also should require issuers to post any corrections to previous issuer statements on the website, with a one-year posting requirement. Owners of stock should not be required to periodically check the issuer websites.

Finally, the proposed regulations should provide that a broker has received notification of an issuer action affecting basis when the broker is notified that such information is on the issuer's website, if the issuer posts the information on the web rather than sending information statements. A broker should not be penalized for failure to make corrections to transfer or information statements until the broker actually has notice of an adjustment that affects the basis originally reported on those statements.

VII. Penalty Provisions

Given the significant burdens that mandatory cost basis reporting will impose on the mutual fund industry, and the very short time frame between the issuance of final regulations and the effective date for such reporting, the Institute asks the IRS and Treasury Department to provide transition relief to the industry. This transition relief should provide that the government will not impose penalties for a failure to properly report basis information to shareholders or the IRS, to the extent the broker has used best efforts to comply. We believe this transition relief should apply at least for the first three years following the effective date for RIC shares.

If the IRS does not provide general transition relief, we ask that the government provide limited transition relief for gifted and inherited shares, if the IRS does not change its stance that these shares are covered securities. Given the complexity of these rules and the fact that the industry did not believe such shares to be covered by the basis reporting statute, additional time is needed to properly comply with these requirements.

Karen Lau Gibian
Associate Counsel

Attachment

endnotes

[1] See Institute Memorandum (23387) to Bank, Trust and Recordkeeper Advisory Committee No. 17-09, Broker/Dealer Advisory Committee No. 21-09, Operations Members No. 9-09, Small Funds Members No. 26-09, Tax Members No. 8-09, Transfer Agent Advisory Committee No. 31-09, dated April 9, 2009.

[2] Section 852(b)(4)(A) provides that if a shareholder receives a capital gain dividend with respect to regulated investment company ("RIC") shares, and the shareholder holds those shares for six months or less, then any loss from the sale of those shares will be treated as a long-term capital loss, rather than short-term, to the extent of the capital gain dividend. Section 852(b)(4)(B) provides that if a shareholder receives an exempt-interest dividend with respect to RIC shares which the shareholder holds for six months or less, any loss on the sale or exchange of those shares is disallowed, to the extent of the tax-exempt dividend.
