COMMENT LETTER

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ICI Comment Letter on Cost Basis Reporting (pdf)

By Electronic Delivery July 28, 2011 Emily S. McMahon William J. Wilkins Deputy Assistant Secretary for Tax Policy Chief Counsel U.S. Department of the Treasury Internal Revenue Service 1500 Pennsylvania Avenue, NW 1111 Constitution Avenue NW Washington, DC 20220 Washington, DC 20224 RE: Cost Basis Reporting – Comments on Notice 2011-56 Dear Ms. McMahon and Mr. Wilkins: The Investment Company Institute1 greatly appreciates the Internal Revenue Service ("IRS") and the Department of the Treasury's response in Notice 2011-56 to our concerns regarding the use of average cost as a default method.2 The rules provided in the Notice are workable and resolve a significant issue for our industry. We urge, as discussed below, that the IRS and Treasury Department adopt these rules in final regulations.3 This letter also addresses a few other cost basis reporting issues for which additional guidance should be provided. First, the Institute asks the IRS and Treasury Department to reconsider its requirement that a shareholder who elects to use the average cost method, revokes such election, or changes from the average cost method (whether the broker default or a shareholder election) must do so in writing. As we discussed in our comment letter on the proposed regulations, requiring such elections, revocations, and changes in writing is unnecessarily burdensome and potentially costly for shareholders.4 The 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.3 trillion and serve over 90 million shareholders. 2 See Institute Letter to Michael Mundaca and William J. Wilkins, dated January 13, 2011. 3 The Institute has no comment on the provisions in the Notice regarding the ten percent reinvestment rule for dividend reinvestment plans ("DRPs"). Because regulated investment companies ("RICs") otherwise are permitted to use average cost, this rule does not affect brokers with respect to RIC shares. We also believe the clarification that lot selection methods should apply on an account-by-account basis is correct; therefore, we do not address it specifically in this letter. 4 See Institute Letter to William J. Wilkins, dated February 8, 2010. This letter commented on the proposed in-writing requirement for an affirmative average cost election. The proposed regulations did not require a revocation of such an election or a change from average cost to be in writing, so the Institute was not given an opportunity previously to comment on these rules. ICI Letter re Notice 2011-56 July 28, 2011 Page 2 of 15 Institute instead proposes that the IRS and Treasury Department permit brokers to provide a written confirmation to shareholders of a cost basis method election, revocation, or change, in lieu of a written notification by the shareholder. The Institute also asks the government to clarify several other issues regarding cost basis reporting. First, the IRS and Treasury Department should clarify that brokers may use any basis method as their default method for mutual fund shares, including first-in, first-out ("FIFO"), average cost, or any other formulaic method, as clearly intended by Congress. Second, we ask the government to provide that gifted shares will have a carryover holding period, even if the shares were gifted at a loss (i.e., the cost basis of the gifted shares exceeds the fair market value on the date of gift) and the donee subsequently sells the shares at a loss. Third, we ask the IRS and Treasury Department to clarify that, for cost basis reporting purposes, shares acquired by an estate after the decedent's death have a basis equal to the fair market value on the date of acquisition, unless the broker receives other information from an estate representative. Finally, the IRS should (i) clarify whether RIC liquidating distributions are subject to cost basis reporting and, (ii) if so, amend Forms 1099-B and 1099-DIV, and the accompanying instructions, to specify that liquidating distributions by RICs should be reported on Form 1099-B, so that brokers can properly report cost basis information for such distributions. Notice 2011-56 – Change from Broker Default Average Basis Method Strong Support for Flexibility Provided by Notice to Change Cost Basis Methodology The Institute strongly supports Notice 2011-56's resolution of an issue that was a significant impediment to effective implementation of the cost basis reporting requirements by RICs and other brokers with respect to RIC shares. Specifically, the Notice reverses a provision in the final cost basis reporting regulations that would have allowed a shareholder to change to another basis method from the broker's default of average cost prospectively only. Thus, a shareholder would have been locked into the broker's default of average cost if the shareholder did not choose a different method before the first covered shares were acquired in the account. As discussed in our January 13 letter, the Institute and its members felt that such a rule was detrimental to shareholders. As a result, brokers were finding it difficult to use average cost as their default method with respect to RIC shares. In response to the industry's concerns, Notice 2011-56 enhances the ability of a taxpayer to change from a broker's default method of average cost to another cost basis method. Specifically, the Notice provides that the basis of a share lot will revert from average cost to the original cost basis of that 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. Brokers must use reasonable means to notify taxpayers that they plan to use average cost as their default method for RIC or DRP shares. ICI Letter re Notice 2011-56 July 28, 2011 Page 3 of 15 Other than the suggestions discussed below, the Institute believes the proposed regulations should adopt the average cost default rules in Notice 2011-56. We believe they strike an appropriate balance between giving shareholders flexibility when choosing basis methods, and permitting brokers to roll up lots and maintain only an average cost for an account, if the brokers deem storage costs for individual lots to be too great. The Notice also gives brokers the flexibility to extend the change period up until the first sale or other disposition, if brokers determine that such a policy is in the best interests of their customers. We understand that most of our members intend to extend this period until the first redemption or other disposition (as with the revocation period for affirmative elections of average cost), because we believe this provides the best customer service to our shareholders.5 Electing, Rather than Changing, Cost Basis Methods Although we agree with the rule in Notice 2011-56 in substance, we suggest changes to the language used to describe the rule. The Notice refers to a "change" from the broker's default method of average cost. We believe this terminology is confusing, because the final regulations include other rules regarding "changes" from average cost.6 In general, we view a "change" from average cost as constituting a choice of a different method (such as FIFO or specific identification), after a redemption has occurred for which average cost was applied. Consistent with this view, the final regulations provide that a "change" is prospective. Use of that term in the context of the Notice is confusing, because it now suggests that a "change" may be retroactive.7 In comparison, if a broker selects average cost as its default method, but no redemptions have yet occurred, the shareholder actually is choosing or electing, rather than changing, a basis method to apply to the account. In the fund industry, brokers do not view any cost basis method, including average cost, as applying to the account until a transaction occurs that requires use of a basis method. Even if brokers choose average cost as their default method for RIC shares, they will not actually apply average cost to the account until the customer redeems or otherwise disposes of the shares. The broker typically maintains an ancillary cost basis system that tracks or calculates the average cost number as shares are acquired, but the broker also will keep the individual lot history, including the acquisition cost, of all the shares in the account.8 Therefore, if a broker chooses average cost as its default method, and the customer notifies the broker before the first redemption that he or she wishes to use a different method, we believe that the customer is electing a method, rather than changing methods, because no method yet 5 Extending the change or revocation period until the first redemption or other disposition gives customers maximum flexibility in choosing a basis method and determining which lots they wish to sell. It also provides consistency among all basis methods (average cost, FIFO, and specific identification), regardless of the broker's default method. 6 See Treas. Reg. § 1.1012-1(e)(9)(iv). 7 The Notice states that, if the shareholder decides to elect another method within the given time frame, the basis of the stock "reverts to the original cost basis." 8 Most funds find the cost of data storage to be minimal. ICI Letter re Notice 2011-56 July 28, 2011 Page 4 of 15 has been applied to the account.9 Even though the average cost method affects all the shares in an account, the basis of those shares are not affected until a transaction occurs that requires average cost to be used. For these reasons, we suggest that the IRS and Treasury Department refer to this as an "election" of a method other than average cost, rather than a "change" from average cost. We also suggest that the proposed regulations delete the reference to the shares "reverting" back to the cost basis. As discussed above, the shares have not lost their original cost basis; no basis method has yet been applied. We believe these changes in terminology will eliminate confusion and better describe how basis methods are applied by industry operating systems. Notification Requirements The Notice should clarify the procedures by which shareholders must notify funds and brokers of their desire to change (or elect, in our parlance) basis methods if the broker's default is average cost. Although the Notice is silent on this point, presumably the IRS and Treasury Department intend to apply the same in-writing requirement that applies to an affirmative average cost election or a change from the average cost method. We believe, as discussed below, that such a writing requirement is unnecessary and should be eliminated. The Notice also includes a new requirement that a broker using average cost as its default must use reasonable means to notify taxpayers. "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 provided by the broker must identify the securities subject to the broker's default average basis method. The IRS and Treasury should adopt these rules in the proposed regulations. We believe they provide enough flexibility to brokers to determine how and when to best communicate their default method to their customers.10 Differences between RICs and DRPs Finally, we ask the IRS and Treasury Department to keep in mind that, although average cost is now available for DRPs as well as RIC shares, there are many differences between the two. Most notably, many RICs have been providing average cost basis information to their shareholders on a voluntary basis for over 20 years. Our industry has a great deal of experience in calculating and reporting average cost. Many non-RIC issuers, however, are facing new and daunting challenges as they implement a cost basis method that they have never before had to use. Rules that may make sense for 9 Average cost should be treated the same as FIFO or specific identification. If a broker's default is FIFO, the shareholder who elects specific identification or average cost before the first redemption is not "changing" methods. 10 In anticipation of 2012, many brokers have made decisions regarding how such communications will occur, and some already have begun communicating with their shareholders regarding default methods. Thus, the proposed regulations should not include any rules more restrictive than these. ICI Letter re Notice 2011-56 July 28, 2011 Page 5 of 15 DRPs may not necessarily make sense for RICs, and vice versa. The average cost default rule is a good example. Although many issuers of non-RIC securities may not wish to maintain individual lot history for DRPs that are using average cost, most brokers plan to do so with respect to RIC shares. Thus, the average cost default rule in the final regulations created numerous complications and burdens for the fund industry, even though other issuers with DRPs may have requested it. Therefore, we respectfully ask the IRS and Treasury Department to carefully consider the potentially divergent effects of any new rules regarding average cost on both DRPs and RICs. Average Cost Elections and Method Changes – In-Writing Requirement The Notice's provisions regarding average cost as a default method, which we support, raise an important issue that should be addressed in new proposed regulations. Specifically, shareholders should be permitted to elect, revoke, or change from the average cost method (including an average cost broker default method) without having to submit the request to their fund or broker in writing. As discussed below, we strongly believe the in-writing requirement is unnecessary and may be detrimental to shareholders. The final regulations require that shareholders who wish to elect average cost as their basis method must do so in writing.11 Shareholders who wish to revoke such an election similarly must do so in writing.12 The regulations also specify that any change from average cost must be in writing; the regulations do not differentiate between a change from the broker's default method of average cost or an affirmative election by the shareholder.13 The guidance in Notice 2011-56 regarding average cost does not specify that changes from the broker's average cost default method must be in writing, but presumably that was the government's intent. In the Institute's comment letter on the proposed regulations, we asked the IRS and Treasury Department to eliminate the in-writing requirement for shareholder elections of average cost.14 We argued that the rule was unnecessary and limited shareholders' flexibility in choosing basis methods. We still strongly believe this to be the case. The addition to the final regulations of an in-writing requirement for revocations of and changes from average cost compounds the problem. 11 Treas. Reg. § 1.1012-1(e)(9)(i). 12 Treas. Reg. § 1.1012-1(e)(9)(iii). 13 Treas. Reg. § 1.1012-1(e)(9)(iv). 14 The proposed regulations did not require a revocation to be in writing. The proposed regulations said, "A revocation is effective when the taxpayer notifies, by any reasonable means, the custodian or agent holding the stock to which the revocation applies." Prop. Treas. Reg. § 1.1012-1(e)(9)(iii). Similarly, the proposed regulations did not require shareholders to notify brokers in writing of a change from average cost, but they did require shareholders to seek consent from the IRS to make such a change. Prop. Treas. Reg. § 1.1012-1(e)(9)(iv). Because these in-writing requirements were not included in the proposed regulations, the Institute was not given an opportunity previously to comment on them. ICI Letter re Notice 2011-56 July 28, 2011 Page 6 of 15 An in-writing requirement for elections or revocations of, or changes from, average cost is unnecessary. Brokers have procedures in place to capture and record all transactions effected by their customers, including both financial and non-financial (maintenance-type) requests. Beginning in 2012, this also will include any basis method elections or changes. The Institute's members do not believe that a written election, revocation, or change provides any additional information or protection to either the broker or the shareholder for information reporting purposes. We do not see any sound policy reasons for requiring elections or revocations of, or changes from, average cost to be in writing. Brokers are permitted under the securities laws to engage in a number of financial and non-financial transactions over the phone, including redemptions or sales of shares, exchanges of shares from one account to another, and maintenance changes on accounts (e.g., changes of address and reinvestment options). Brokers have procedures and controls in place to ensure that transactions are processed accurately and timely, and to prevent fraudulent activity. Such procedures include, but are not limited to, authenticating customers' identity, capturing, processing and recording the requested account or transaction activity as part of the books and records for the shareholder account, and communicating or confirming that requested transactions have been effected. These procedures are deemed sufficient for both monetary and non-monetary transactions today. They similarly should be considered sufficient for cost basis reporting purposes. The in-writing requirement also is overly burdensome and detrimental to shareholders. To the extent that a shareholder redeems shares or makes changes to his or her account over the broker's website, the in-writing requirement is not a problem, because the final regulations provide that a writing may be electronic.15 A significant portion of customer communications, including redemptions, however, occurs over the phone. One large fund company estimates that about 13% of its redemptions for taxable accounts held directly at the fund were made over the phone during the second quarter of 2011. A large external transfer agent for the industry, which services approximately 40% of the accounts held directly by funds, processed over 950,000 telephone redemptions in 2010.16 Based on these numbers, we estimate that there are millions of telephone transactions that take place in the mutual fund industry each year. An increasing number of the shareholders who redeem over the phone after the cost basis reporting rules become effective surely will want to choose or change their basis method as part of their transaction request. The sporadic manner in which the in-writing requirement applies does not appear to have tax policy support. If the broker's default method is FIFO, for example, and the shareholder wishes to specifically identify which shares he or she wishes to sell, the shareholder can do that over the phone. If the broker's default is FIFO and the shareholder wishes to choose average cost, however, the shareholder cannot do so over the phone. Similarly, if the broker's default is average cost, and the shareholder who calls to redeem shares wishes to choose FIFO or to specifically identify shares, he or 15 Treas. Reg. § 1.1012-1(c)(9)(i). 16 The majority of taxable accounts are held and serviced through intermediaries, rather than directly with the funds. The percentage of these shareholders who redeem or make other transactions by phone likely is significant. she cannot do so. Finally, if the shareholder has affirmatively elected average cost but wishes to revoke that election or to change to another method prospectively, he or she cannot do so over the phone. The different requirements for the situations described above will be confusing and potentially harmful to shareholders. In the latter three situations, the final regulations effectively will force the customer service representative or broker to inform the shareholder that he or she must provide that basis method election, revocation, or change in writing. Consequently, the shareholder will be forced to hang up the phone and send a written letter, an e-mail, a fax, or some other "writing" to re- communicate his or her wishes. Some shareholders may not have immediate access to any means for sending their election or change in writing. If the shareholder is redeeming shares, this processing delay may expose the shareholder to market fluctuations that may produce investment losses. In market conditions like the present, such losses can be significant. Forcing investors to bear market risk to preserve an unnecessary writing requirement makes no sense. The Institute's members wish to continue making shareholders' experiences as efficient, accurate, and secure as they are today, without processing delays that result from the in-writing requirement. The preamble to the final regulations states that the government believes elections of average cost should be in writing to provide both the shareholder and the broker “a record of the fact and scope” of the election. As discussed above, brokers already have procedures in place to do so. If, however, the government feels that the shareholder should have some written record of the election or method change, the Institute suggests that the new proposed regulations require brokers to provide customers with a written confirmation, by any reasonable means, of their average cost election, revocation, or change in method, instead of requiring the shareholder to provide it in writing.17 This would be similar to the current requirement for confirmation of specific identification of securities.18 If the shareholder is redeeming shares when the election, revocation, or method change is made, such election, revocation, or change could be reflected on the confirmation or account statement.19 Otherwise, the broker could send a separate confirmation.20 In essence, this proposal would shift the burden of the in-writing requirement from the shareholder to the broker. We believe our proposed change should satisfy the IRS and Treasury Department’s concerns without creating unnecessary burdens on shareholders. Moreover, this proposal would not prevent a broker from requiring, as a business matter, that its shareholders provide cost basis elections, revocations, or method choices in writing. 17 As with all other writings required under the cost basis reporting rules, this confirmation could be provided electronically. 18 Treas. Reg. § 1.1012-1(c)(3)(i)(b). 19 Such confirmation or account statement would be sent to the shareholder of record at the address of record. 20 Brokers today often send “account maintenance confirmations,” to confirm any changes made by a shareholder to their account information. ICI Letter re Notice 2011-56 July 28, 2011 Page 8 of 15 Permissible Default Methods for RIC Shares Section 6045 requires brokers to report basis to RIC shareholders using the broker’s “default method,” an undefined term, if the shareholder does not properly choose another method. Because of confusion regarding which methods are available as “defaults,” we ask the IRS and Treasury Department to clarify that brokers may use any formulaic method as their default cost basis method for RIC shares. Section 6045(g)(2)(B)(i)(I) provides that, for equities other than RIC shares, the broker must report the shareholder’s adjusted cost basis using FIFO, unless the shareholder notifies the broker that he or she wishes to specifically identify the shares to be sold. For RIC shares, section 6045(g)(2)(B)(i)(II) provides that the broker must report the shareholder’s adjusted cost basis “in accordance with the broker’s default method unless the customer notifies the broker that he elects another acceptable method under section 1012 with respect to the account in which such stock is held.” The statute does not define “default method” for these purposes. During our discussions with Congressional staff on the cost basis reporting bills, the legislative intent clearly was to permit brokers to use any default method with respect to RIC shares. These permissible methods included FIFO and average cost, as well as any formulaic method of specific identification (e.g., highest-in, first-out, or “HIFO”). The Joint Committee on Taxation’s explanation of the legislation memorializes this intent: The adjusted basis of stock for which an average basis method is permissible under section 1012 is determined in accordance with the broker’s default method under section 1012 (that is, the first-in, first-out method, the average cost method, or the specific identification method) unless the customer notifies the broker that the customer elects another permitted method.21 Thus, brokers are permitted to choose any basis method allowable under section 1012 as a default method for RIC shares. A formulaic method of specific identification, such as a standing order to apply HIFO, is a basis method allowable under section 1012. Treas. Reg. § 1.1012-1(c)(1) provides that a taxpayer determines the basis of stock sold using the FIFO method, unless the taxpayer makes an adequate identification of the stock to be sold. Where the stock is held in the custody of a broker or other agent, a taxpayer has made an “adequate identification” if, at the time of the sale, the taxpayer specifies to the broker the particular stock to be sold, and the broker provides written confirmation of such specification within a reasonable time thereafter.22 The final regulations on cost basis reporting clarify that a standing order 21 General Explanation of Tax Legislation Enacted in the 110th Congress, Joint Committee on Taxation, JCS-1-09, p. 364 (emphasis added). 22 Treas. Reg. § 1.1012-1(c)(3)(i). ICI Letter re Notice 2011-56 July 28, 2011 Page 9 of 15 or instruction for the specific identification of stock is treated as an adequate identification of stock made at the time of sale, transfer, delivery or distribution.23 Prior to the issuance of the final regulations on cost basis reporting, it was well established under existing law that a standing order is an adequate identification of stock under section 1012. In Rev. Rul. 61-97, 24 the IRS ruled that a systematic liquidation over a period of time is an adequate identification of stock under Treas. Reg. § 1.1012-1(c), provided the owner’s instructions to the broker clearly identify the order to be followed in disposing of stock acquired in different lots. The IRS specifically has applied the holding in Rev. Rul. 61-97 to a HIFO standing order in PLR 9728021, finding that such a formulaic method complies with Treas. Reg. § 1.1012-1(c)(3). In Concord Instruments Corporation,25 the Tax Court held that a taxpayer who orally instructed its broker to sell the highest cost shares first adequately identified the stock under Treas. Reg. § 1.1012-1(c)(3), even though the broker did not provide written confirmation of those instructions. A formulaic method of specific identification clearly is an acceptable means of adequate identification under section 1012. Given Congress’ intent to permit brokers to use any method permissible under section 1012 as their default method for RIC shares, it thus is clear that brokers can choose a formulaic method of specific identification as their default method. We understand there has been some confusion, however, as to whether brokers may choose a default method other than FIFO or average cost for RIC shares. If Congress had intended to limit brokers’ choices to these two methods, Congress would have done so expressly in the statute, as it did with respect to other equities. In fact, earlier versions of the cost basis reporting bills specifically limited brokers to the use of average cost for RIC shares. Following discussions with the industry, Congress agreed to permit the use of any basis method, and therefore intentionally made the statutory language broad in scope. Although the ability of a broker to choose any default method should be clear, we ask the IRS and Treasury Department to clarify this issue and alleviate further confusion. Specifically, the regulations expressly should provide that brokers may use FIFO, average cost, or any formulaic method of specific identification as a default method for RIC shares. Shares Gifted at a Loss – Holding Period The detailed broker reporting rules of section 6045(g) and the regulations thereunder do not address the holding period that brokers must report for gifted shares. We urge, as discussed below, that the IRS and Treasury Department clarify that brokers must use a carryover holding period in all cases. 23 Treas. Reg. § 1.1012-1(c)(8). 24 1961-1 C.B. 394, clarified in Ann. 61-77, 1961-36 I.R.B. 34. 25 T.C. Memo 1994-248. ICI Letter re Notice 2011-56 July 28, 2011 Page 10 of 15 Section 6045(g) requires brokers to report to the IRS and the shareholder the adjusted basis of covered shares sold or redeemed, as well as whether any gain or loss is long-term or short-term. Because gifted securities are covered securities under the final regulations, brokers must apply the relevant basis rules under section 1015 if a transfer statement indicates that shares were acquired as a gift.26 The adjusted cost basis of shares that are gifted at a loss (i.e., the fair market value on the date of gift is less than the donor’s basis) depends on the price at which the donee later sells the gifted shares.27 Thus, a transferor must report on the transfer statement both the fair market value on the date of gift and the donor’s adjusted cost basis.28 The transferor also must report both the date of the gift and the donor’s original acquisition date.29 The final regulations, however, do not address the holding period that the broker must report on the Form 1099-B for gifted shares. In general, a donee will take a carryover holding period from the donor.30 In July, 2010, the Institute submitted a letter to the Treasury Department discussing our understanding that a beneficiary's holding period in inherited shares, which is long-term under section 1223(9), carries over in all cases if the beneficiary transfers the shares by gift.31 Thus, the donee's holding period in the gifted shares that previously were inherited will be long-term regardless, among other things, of the period between the decedent's death and the donee's sale of the securities. After the Institute's July 2010 letter was submitted, we were made aware of some old IRS guidance on section 1223(2) that called into question that understanding in some cases. Section 1223(2) states: In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person. Under these old rulings, the IRS interpreted this language narrowly and held that the donor's holding period does not carry over to property gifted at a loss unless the donee ultimately uses the donor's 26 Treas. Reg. § 1.6045-1(d)(6)(ii)(B)(2). 27 See section 1015(a). 28 Treas. Reg. § 1.6045A-1(b)(6)(i). 29 Id. 30 See section 1223(2). 31 See Institute Letter to Jeanne Ross, dated July 14, 2010. ICI Letter re Notice 2011-56 July 28, 2011 Page 11 of 15 basis.32 In other words, if shares are gifted at a loss, and the donee subsequently sells the shares at a loss, the holding period for the gifted shares restarts on the date of gift. We believe that section 1223(2) should not be interpreted this narrowly. A donee should receive a carryover holding period regardless of the basis that subsequently is used to determine the donee's gain or loss. Section 1223(2) permits tacking of holding periods if the donee uses "in whole or in part" the basis of the donee "for the purpose of determining gain or loss." We submit that these two phrases should be read together to conclude that a donee of shares gifted at a loss, who would use the donor's basis if the shares subsequently were sold for more than the donor's basis (i.e., for a gain), need not actually do so. If the purpose were to limit tacking of the holding period to situations in which the donee actually uses the donor's basis, the phrase could have read, "for purposes of determining gain and loss." We are not aware of any tax policy reasons for interpreting section 1223(2) narrowly. The rules regarding gifts at a loss are intended to prevent taxpayers from shifting losses to taxpayers who better could utilize them to reduce tax liabilities. The IRS's narrow interpretation of section 1223(2) seems to provide donees who receive gifted shares at a loss with a potential tax advantage that would not be available to taxpayers who receive appreciated gifts. Specifically, donees who receive depreciated gifted shares with a long-term carryover holding period who then sell those shares within a year at a loss will have a short-term loss, which can be used to offset ordinary income. Conversely, donees who receive appreciated gifted shares with a long-term carryover holding period who sell those shares within a year at a loss will have a long-term loss. In the broker-reported cost basis context, requiring a holding period rule that is dependent upon a subsequent sale makes little sense. Brokers' cost basis reporting systems track holding periods of shares based upon the acquisition date of the shares. For gifted securities, the acquisition date is the donor's acquisition date. The system also will record the date of the gift, but for holding period purposes, whether the security should be characterized as long-term or short-term depends on the acquisition date record. The IRS's interpretation of section 1223(2) would require the cost basis reporting system, upon a sale by the donee, to go back and determine the holding period based upon the date of gift, rather than the acquisition date, if the shareholder did not sell the gifted shares at a gain. This would require complex and expensive programming to properly capture the change in holding period and to create and keep a record of why the change took place. These record changes likely would be confusing to both the reporting broker and the shareholder. Given the infrequency with which such transactions are likely to occur, the industry strongly feels such complex programming is unwarranted. Given the wording of section 1223(2) and the difficulties of applying a narrow interpretation of the statute in the context of cost basis reporting, we urge the IRS to reconsider its views on this issue. 32 See I.T. 3453, 1941-2 C.B. 254, declared obsolete by Rev. Rul. 69-43, 1969-43, 1969-1 C.B. 310; Rev. Rul. 59-416, 1959-2 C.B. 159 (holding (3)). ICI Letter re Notice 2011-56 July 28, 2011 Page 12 of 15 Specifically, we ask the IRS to provide that a donee receives a carryover holding period from the donor in all cases. Cost Basis of Inherited Shares Acquired by an Estate The IRS and Treasury Department should clarify the regulatory requirements for reporting transfers from a decedent or decedent's estate to address shares acquired by dividend reinvestment after the decedent passes away. Specifically, the regulations clearly should provide that these post-death shares have a cost basis equal to the acquisition cost of such shares. The final regulations provide that a transfer reporting statement is required when shares are transferred from a decedent or a decedent's estate.33 The general rule is that the transferor must report the adjusted basis as the fair market value on the date of death, unless the broker receives instructions or valuations furnished by an authorized representative of the estate. The final regulations do not differentiate, however, between shares acquired during the decedent's lifetime and those acquired by the estate thereafter. The Institute thus asks the IRS and Treasury Department to amend the final regulations to provide that the adjusted basis for shares acquired by the estate, after the decedent's death, should be the estate's acquisition cost for such shares. Most mutual fund shareholders automatically reinvest their dividends. Thus, when a shareholder dies, additional shares may be acquired by the shareholder's estate as part of a dividend reinvestment program, before the account is transferred to the shareholder's heirs. The general rule in section 1014 is that inherited shares have an adjusted basis equal to the fair market value on the date of death, but the regulations provide an exception for reinvestments by a fiduciary. This rule provides that the basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value at the date of death.34 Reinvested dividends fall under this exception, and the adjusted basis generally will be the acquisition cost. Despite the substantive rules, the final regulations under section 6045A, as written, seem to require the transferor to use the fair market value on the date of death as the adjusted basis for any shares acquired by the estate, absent instructions from an estate representative. This result is illogical, however, because those shares were acquired by the estate after the date of death. Further, it contradicts the rules under section 1014.35 The only other possible interpretation of the final regulations is to treat shares acquired by the estate after the date of death as inherited but noncovered for cost basis reporting purposes. The regulations provide that "if the transferor neither knows nor can readily ascertain the 33 Treas. Reg. § 1.6045A-1(b)(5)(i). 34 Treas. Reg. § 1.1014-3(c). 35 Not only does this rule contradict the substantive cost basis rules, but we understand it is extremely difficult to program. Basis reporting systems cannot easily capture a fair market value on a certain date for shares that were not held in the account on that date. ICI Letter re Notice 2011-56 July 28, 2011 Page 13 of 15 fair market value of the security on the date of death," then the transferor may treat those securities as noncovered.36 Although this interpretation is workable, it is not likely the intended result. Given the problems with the transfer reporting rule for inherited securities, we ask the IRS and Treasury Department to amend the final regulations to provide that the adjusted basis for shares acquired by an estate will be the estate's acquisition cost, unless the estate representative provides an alternate valuation. The rule for transfer reporting thus would follow the substantive rules under section 1014. Information Reporting on Liquidating Distributions Brokers currently must report liquidating distributions by a corporation on Form 1099-DIV, according to the instructions for the form. It is unclear, however, whether liquidating distributions by a RIC are subject to mandatory cost basis reporting under section 6045(g). The IRS thus should clarify whether brokers must report cost basis information upon a RIC liquidation. If such distributions are subject to cost basis reporting, the IRS should amend Forms 1099-DIV and 1099-B to specify that liquidating distributions by RICs should be reported on Form 1099-B. Section 331 provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock.37 Thus, a shareholder who is paid in full by a RIC that is completely liquidating treats that payment as amounts received in redemption of its shares.38 The shareholder will have capital gain or loss to the extent that the amount he or she receives exceeds his or her adjusted cost basis in the shares. This suggests that a liquidating distribution by a RIC should be treated as redemption and, therefore, subject to reporting under section 6045.39 It currently is unclear, however, whether liquidating distributions are subject to cost basis reporting under section 6045(g). The cost basis reporting requirements in section 6045(g) apply “if a broker is otherwise required to make a return” under section 6045(a). Section 6045(a)(1) defines the term “broker” for purposes of gross proceeds reporting as any person that stands ready to effect sales to be made by others, other than a person who is required to report a transaction under section 6043. Section 6043 requires a corporation that has adopted a plan or resolution for the liquidation of its capital stock to file a return with the IRS. This suggests that liquidating distributions may not be 36 Treas. Reg. § 1.6045A-1(b)(5)(i). 37 Section 331(b) further provides that section 301 (relating to distributions of property) generally shall not apply to any distribution of property in complete liquidation. 38 RICs generally do not partially liquidate. 39 The regulations under section 6045 define a “sale” as any disposition of securities, including redemptions of stock, to the extent the transaction is conducted for cash. Treas. Reg. § 1.6045-1(a)(9). ICI Letter re Notice 2011-56 July 28, 2011 Page 14 of 15 subject to gross proceeds reporting under section 6045(a) and, consequently, cost basis reporting under section 6045(g).40 Currently, liquidating distributions are reported on Form 1099-DIV, which includes boxes for “cash liquidation distributions” (box 8) and “noncash liquidation distributions” (box 9). Publication 550, “Investment Income and Expenses,” explains to taxpayers that “liquidating distributions … are distributions you receive during a partial or complete liquidation of a corporation.”41 The publication then explains that “any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain.”42 Under prior law, reporting liquidating distributions on the Form 1099-DIV was not problematic because brokers’ only obligation was to report the amount of the distribution. The shareholder was informed in Publication 550 that such amounts might constitute capital gain or loss, and the obligation to correctly report the character of the distribution fell upon the shareholder. The new cost basis reporting rules, however, now require brokers to report shareholders’ cost basis and holding period upon a sale, transfer, or other disposition. If liquidating distributions are subject to mandatory cost basis reporting, brokers will have no means for reporting such information to shareholders and the IRS on the Form 1099-DIV. The Institute thus urges the IRS to clarify whether liquidating distributions by RICs are subject to information reporting under section 6045, including cost basis reporting. If such distributions are subject to reporting under section 6045, the IRS should amend Forms 1099-DIV and 1099-B, and the accompanying instructions, to provide that liquidating distributions by RICs should be reported on Form 1099-B. This change is necessary to ensure that brokers can properly comply with the new cost basis reporting requirements. * * * 40 The interaction between sections 6043 and 6045 suggests that if the RIC itself is the broker (i.e., the shareholder has an account directly with the fund), then it is not required to report under section 6045 upon a liquidation of the RIC. A broker/dealer, however, does not file an information return under section 6043, and therefore may be subject to reporting under section 6045 for the same liquidation. 41 Publication 550, p. 22. 42 Id. ICI Letter re Notice 2011-56 July 28, 2011 Page 15 of 15 The Institute appreciates the opportunity to comment on Notice 2011-56 and other cost basis reporting issues. We will contact your offices shortly to arrange a meeting to discuss these complex issues. In the meantime, should you have any questions or need additional information, please contact me at (202) 371-5432 or kgibian@ici.org. We look forward to discussing these issues with you further. Sincerely, /s/ Karen L. Gibian Karen Lau Gibian Associate Counsel – Tax Law cc: notice.comments@irscounsel.treas.gov Jeffrey Van Hove Michael Novey Brandon Carlton Catherine Hughes George Blaine Deborah Butler Donna Crisalli Amy Pfalzgraf Carlton King Edward C. Schwartz