INVESTMENT COMPANY INSTITUTE

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By Electronic Delivery

May 25, 2010

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

RE: Additional Comments on Proposed Regulations on Cost Basis Reporting

Dear Mr. Wilkins:

The Investment Company Institute[1] wishes to provide additional comments on several issues raised by the proposed regulations on cost basis reporting. Specifically, as mentioned in the Institute's February 8 comment letter, we have additional remarks on the proposed rules regarding gifted and inherited shares. As discussed in more detail below, the regulations as proposed by the Internal Revenue Service ("IRS") and Treasury Department raise a number of implementation and calculation issues for brokers, including mutual funds. The Institute and its members urge the IRS and Treasury Department to adopt default rules that are workable yet ensure compliance with the cost basis reporting rules.

The Institute also wishes to clarify a comment made in our February 8 comment letter regarding the need to send transfer statements for exempt recipients. In addition to the exempt recipients listed in Treas. Reg. § 1.6045-1(c)(3)(i)(B), applicable persons should not be required to send transfer statements for any of the exceptions listed in Treas. Reg. § 1.6045-1(c)(3), including money market funds.[2] As with exempt recipients, the requirement to send transfer statements for transfers of money market fund accounts is unnecessary and overly burdensome.

Finally, the Institute has concerns regarding a recent suggestion that the IRS should designate tax-advantaged retirement account custodians or trustees as "applicable persons" for purposes of the transfer reporting rules when a shareholder takes an in-kind distribution from a tax-advantaged retirement account (such as an individual retirement account). For the reasons discussed below, the

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[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 $11.94 trillion and serve almost 90 million shareholders.

[2] See Treas. Reg. § 1.6045-1(c)(3)(vi).

Institute does not believe that tax-advantaged retirement account custodians or trustees should be included within this definition.

Inherited Shares

The proposed regulations require an applicable person to send a transfer statement when shares are transferred to a new owner due to the death of the original owner, provided that the shares were covered securities when held by the original owner. In addition to the information otherwise required on a transfer statement, the proposed regulations require the applicable person to include the date of death as the original acquisition date and the adjusted basis of the shares according to the instructions and valuations provided by an authorized representative of the estate, taking into account any additional adjustments required by the Internal Revenue Code. The proposed regulations require an applicable person to affirmatively seek adjusted basis information from an authorized estate representative; if the applicable person does not receive the information after making such a request, the inherited shares may be treated as "non-covered." If, however, the applicable person later receives such information, it must send an amended transfer statement treating the shares as "covered" and including the required information.

These proposed regulations raise a number of implementation issues for mutual funds. First, the proposed regulations place an affirmative burden upon brokers to seek information from a third party upon a transfer of inherited shares. This adds a manual component to a process that otherwise will be automated. As part of a request to transfer shares to an account with another broker, transfer systems will be designed to invoke transfer reporting statements from ancillary cost basis reporting systems upon the movement of shares. If the proposed rule for inherited shares is adopted, however, brokers will have to establish manual procedures that include dedicated servicing teams (that are not tax preparers) to handle the required research and follow-up for transfers of inherited shares.

The broker likely will not know who the "authorized estate representative" is, and determining the identity of this person will be time-consuming and costly.[3] In many cases, there may not be an actual estate or an authorized representative who can provide basis information. The proposed regulations require applicable persons to ask the authorized estate representative for this information only once; if they do not receive such information, the applicable person may treat the shares as "non-covered." Given the difficulties in obtaining this information and the compressed timeframes in which transfer reporting for covered securities should occur, we believe that the result of this proposed rule

[3] The proposed regulations do not define "authorized estate representative." It often will not be clear who the broker is required to contact to get the required information, and the proposed regulations do not specify how much effort a broker must exert in trying to identify that person. For example, a broker may first contact a joint account owner or a designated beneficiary, who may not be the "authorized estate representative" and may not have the required information; it is not clear whether the broker then has to make additional inquiries from others to seek this information. Even if the broker can determine the identity of the authorized estate representative, such representative likely will not be able to provide any valuation in time for the transfer to occur on a timely basis, and the shares will be considered "non-covered" if and until such information is provided.

will be that most inherited securities will become non-covered and therefore outside the cost basis reporting requirements.

Finally, implementation issues will arise when a broker is not informed of a death until years later. This scenario frequently occurs with respect to joint accounts, where both account owners have authority to redeem shares. Often, the surviving account owner may not inform the broker when the other account owner dies. The broker may not learn of the death until years later, when the surviving owner closes the account, transfers the account, or also dies. A broker may not learn of a death even with respect to a single account owner who has died; the beneficiary may not inform the broker of the death until the beneficiary wishes to redeem shares or close the account, which may occur years after the death of the original account owner. In either case, when the broker is informed of the death, the proposed regulations seem to require the broker to (i) seek basis information from the authorized estate representative, which is made more difficult by the lapse in time from the original date of death, (ii) provide a transfer statement with the adjusted basis for the surviving account owner or beneficiary, and (iii) file amended Forms 1099 for any redemptions that occurred after the initial death.[4]

The Institute strongly recommends that, given the difficulties with the proposed regulations, the IRS adopt the default rule suggested in our February 8 letter. Under this default rule, brokers, upon notification of a death, would adjust the basis of the inherited shares to the fair market value on the date of death.[5] For joint account owners, the default rule would require a proportionate adjustment to basis. The default holding period would be long term. If a broker later receives information from a beneficiary or an authorized estate representative that the adjusted basis should be something other than the fair market value upon date of death, the broker would be permitted to accept such information for basis reporting purposes, with appropriate penalty relief.

The Institute believes that such a default rule will result in more inherited shares remaining "covered" securities than under the proposed regulations and will result in timely transfer reporting to receiving brokers. Given the inherent difficulties with seeking information from a third party, many inherited shares may become "non-covered" under the proposed regulations. With respect to mutual fund shares, it is fairly straightforward to design cost basis reporting systems that will adjust the basis of inherited shares to the fair market value on the date of death (which would be the closing net asset value ("NAV") on that day); the Institute believes that, in a majority of cases, this adjusted basis will be the correct basis. Therefore, adopting the Institute's suggested default rule will result in more reportable basis information to the IRS and shareholders.

The Institute also recommends that the IRS limit required amendments to transfer statements and Forms 1099 to the three years prior to the receipt of any corrected information. As discussed

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[4] Filing amended Forms 1099 would require brokers to retain all lot information for an account, even after shares have been redeemed, until all the owners of the account are known to be deceased or the account is closed. Without this prior transaction history, brokers could not go back and adjust the basis information for prior redemptions.

[5] This is the general rule set forth in section 1014(a), which provides that the basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property at the date of the decedent's death.

above, brokers may not receive notification of a death until years later. In such cases, it would be costly and burdensome to both brokers and the IRS, not to mention extremely confusing for shareholders, if brokers were required to amend transfer statements and information reporting statements years after their original issuance. This would be a manually intensive, time-consuming and costly process for both brokers and shareholders.

Gifted Shares

Under the proposed regulations, when a transfer of securities occurs as a result of a gift, the transfer statement must indicate that the security is a gift and must report the date of the gift (if known when furnishing the statement) and the fair market value of the gift on that date (if known or readily ascertainable at the time the transfer statement is prepared). This information must be supplied in addition to that otherwise required on a transfer statement.

The proposed regulations also provide that if the transfer statement indicates that a security has been acquired as a gift, the receiving broker must apply the relevant basis rules for property acquired by gift in determining the initial basis, other than adjustments arising solely from gift tax paid with respect to the gift. Under current law, when a donee receives a gift for which the adjusted basis is greater than the fair market value at the time of the gift (*i.e.,* the gift is made at a loss), the basis used to determine gain or loss upon a subsequent sale by the donee depends on the price at which the gifted property is sold. Thus, under the proposed regulations, brokers must retain both the adjusted basis and the fair market value of the shares on the date of gift until a subsequent sale, at which point the broker must apply current law and report the correct adjusted basis.[6] The proposed regulations state that if the application of the relevant basis rules prevent both gain and loss from being recognized upon a subsequent sale, or if the initial basis of the security depends upon its fair market value on the date of gift but the transfer statement does not report its fair market value as of the date of the gift (and this amount is not readily ascertainable by the broker), the broker must treat the initial basis as equal to the gross proceeds from the sale.

The proposed rules for gifted securities are very complex and will be quite costly to build for a relatively small number of transactions. Significant additional data storage and programming will be necessary to apply the proposed regulations for gifted shares. In 2009, there were 24.1 million individuals with taxable long-term mutual fund accounts for which some basis reporting may be

[6] The fair market value on the date of gift is relevant upon a subsequent sale only if the donor's adjusted basis on the date of gift was greater than the fair market value at that time. If the fair market value on the date of the gift is greater than the donor's basis at that time, the donee simply takes a carryover basis. In those cases, there is no need for the donee's broker to receive or retain the fair market value on the date of gift. The proposed regulations, however, do not differentiate between these two scenarios and require the transfer statement always to include the fair market value upon date of gift. If the IRS retains the rule in the proposed regulations, it should amend the rule to provide that the fair market value is required on the transfer statement only if the fair market value on the date of gift is less than the donor's adjusted basis. If the transfer statement includes the fair market value on the date of gift, but the receiving broker does not need that information (because the donor's adjusted basis is less than the fair market value), presumably the receiving broker does not need to retain that information on its books and may discard it.

required beginning in 2012, once additional shares are acquired in these accounts. The vast majority of these accounts will never have a transfer of gifted shares, much less a transfer of gifted shares at a loss (requiring dual tracking of both the donor's carryover basis and the fair market value at the time of the gift). This dual tracking will require a significant expansion of data storage, however, even though this space likely will not be populated for most transfers. Once these data fields have been added, the cost basis reporting system will have to check every account to see if these fields are populated before performing any routine cost basis-related calculation. If the fields are populated, both numbers will need to be updated (*e.g.*, corporate actions that affect basis will need to be applied to both numbers). When finally there is a sale of the gifted shares, which may occur years after the original gift, the broker's system will need to compare and contrast data to determine how to apply the gifting rules. The programming for this will be difficult to build, but will be used very rarely. As a result, shareholders will assume the burden of millions of dollars of coding for a very obscure scenario that will not affect the vast majority of accounts.

Another complication arises with the use of the average cost method. The current and proposed regulations under section 1012 provide that a taxpayer generally may not use the average cost method with respect to gifted shares if the basis of those shares in the hands of the donor was greater than the fair market value of the shares at the time of the gift.[7] The taxpayer, however, may use average cost with respect to those shares if the taxpayer provides a written statement to the IRS indicating that the basis of such gifted shares shall be the fair market value at the time of the gift, and that such basis will be used in computing the average cost.[8] The interaction of this rule with the cost basis reporting requirements creates operational difficulties if a shareholder already has an account for which average cost is being used, and the shareholder receives a gift at a loss of shares in the same fund. Because the donor's basis of the gifted shares is greater than the fair market value of the shares at the time of gift, the donee shareholder cannot use average cost for those shares, and presumably the broker must treat them as being in a separate account for basis method purposes, even though the shares otherwise are identical.[9] The scenario becomes more complicated if the shareholder already has both covered and non-covered securities in the account; with the addition of the gifted shares, the broker now must treat the account as three separate accounts.[10]

Brokers can use average cost for shares gifted at a loss if the shareholder states in writing that they agree to use the fair market value of the shares at the time of the gift as the basis for average cost

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[7] Treas. Reg. § 1.1012-1(e)(1)(ii)(a); Prop. Treas. Reg. § 1.1012-1(e)(8)(i).

[8] Treas. Reg. § 1.1012-1(e)(1)(ii)(b); Prop. Treas. Reg. § 1.1012-1(e)(8)(ii).

[9] The proposed regulations, however, do not specify that brokers may treat the gifted shares as an account separate from the other shares in the account.

[10] An additional problem occurs if a shareholder holds an account for some period of time before the first redemption without making a basis method election. If the shareholder chooses average cost upon the first redemption, the broker will have to go back and check the account history to ensure that no gifted shares were transferred into the account at a loss before it can apply the average cost method.

calculation purposes. Under the proposed regulations, this statement must be provided at the time of the transfer. Obtaining this written statement, however, would require additional communication with the shareholder and could delay the transfer of the shares to a new account with another broker. If and until the broker received such written statement, it still would need to segregate the gifted securities from the other shares in the account. Explaining these rules to the shareholder, to obtain a statement in writing, would result in significant confusion. Follow-up and resolution of the missing information also would be a manual process, which would be costly and time-consuming for both brokers and shareholders.

Further, requiring brokers to apply the basis rules for gifted shares essentially is putting brokers in the role of a tax preparer. Brokers are not equipped for this function, and application of the basis rules for gifted shares should be left to shareholders and their tax advisors and preparers. Excepting brokers from this responsibility for reporting purposes does not mean that shareholders would be free to ignore the rules under section 1015; rather, taxpayers still would have an obligation to apply current law. Congress already has recognized the limited ability of brokers to apply certain Code provisions for reporting purposes; the statute does not require brokers to report wash sales that occur across accounts. Taxpayers, however, still have the obligation to apply the wash sales rules. Similarly, there is no reason why taxpayers should not be required to apply the gift rules even if brokers are not required to apply them for reporting purposes.[11]

Given the significant complexity and enormous additional cost of implementing the proposed rules regarding gifted shares, the Institute reiterates its recommendation that the IRS adopt a simple default rule. Pursuant to this default rule, brokers would assume a carryover basis and holding period for gifted shares. In most cases, particularly with respect to mutual funds, this carryover basis likely will be the correct basis. As with wash sales, however, the taxpayer still would be required to apply the basis rules for gifted shares. If the donor's basis is something other than the carryover basis, the broker could take such information from the shareholder.[12]

To address fraud concerns, the IRS could require brokers to flag any gifted securities on the Form 1099-B. This would alert the IRS that the gifted securities may be subject to special rules and might warrant additional scrutiny by the government.

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[11] Wash sales across accounts are more likely to occur than gifted securities at a loss. Congress, however, exempted wash sales that occur across accounts from the basis reporting requirements because it recognized the substantial administrative difficulties of applying such a rule. Similarly, the IRS should weigh the limited benefits of requiring brokers to apply the rules for gifts at a loss with the significant administrative burdens of implementing these rules.

[12] If the IRS and Treasury Department decide to finalize the current proposed rule on gifted securities, they must address the issue of average cost with respect to securities that have been gifted at a loss. The final regulations will need to provide rules explaining how brokers should treat gifted loss shares that are transferred into an account for which the average cost method already is being used.

Exempt Securities – Money Market Funds

The proposed regulations presume that every security transferred is a covered security, and therefore every transfer must be accompanied by a transfer statement. This rule applies even with respect to transfers of securities that otherwise are exempt from reporting under section 6045. In our February 8 letter, the Institute recommended that the IRS amend this proposed regulation so that transfer statements are not required with respect to securities held by exempt recipients. We wish to clarify that the proposed regulations should not require transfer statements with respect to any sales for which information reporting is not required under Treas. Reg § 1.6045-1(c)(3). This includes, but is not limited to, shares in a money market fund.

Treas. Reg. § 1.6045-1(c)(3)(vi) provides that no return of information is required under section 6045 with respect to a sale of an interest in a RIC that can hold itself out as a money market fund under Rule 2a-7 under the Investment Company Act of 1940 and that computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public (*e.g.*, $1 per share). As with accounts held by exempt recipients, requiring transfer statements for transfers of shares in money market funds is superfluous and unnecessarily burdensome. The information currently transferred with such securities indicates that they are shares in a money market fund and, therefore, tax reporting is not required. A transfer statement (which does nothing more than indicate that the shares are "non-covered" for basis reporting purposes) is of no use to the receiving broker. The Institute thus asks the IRS to exempt from the transfer reporting requirements any sales that are excepted from gross proceeds reporting under section 6045, including sales of shares in money market funds.

In-Kind Distributions

Under the proposed regulations, an applicable person is defined as (i) a broker as defined in the proposed regulations, (ii) any person that acts as a custodian of securities in the ordinary course of a trade or business, (iii) any issuer of securities, and (iv) any agent of these persons. A commenter has suggested that the IRS clarify that a custodian or trustee of a tax-advantaged retirement plan or account is an applicable person with a duty to provide a transfer statement at the time securities are distributed to an owner or an heir (an "in-kind distribution"). This commenter stated that the custodian or trustee should provide the fair market value for each distributed security on the transfer statement as of the date of distribution or date of death, as applicable. For the reasons discussed below, the Institute strongly disagrees with this recommendation, and urges the IRS to provide that tax-advantaged retirement account custodians or trustees are not applicable persons with respect to in-kind distributions or otherwise.[13]

[13] As discussed above and in our February 8 comment letter, the Institute asks the IRS to provide that the transfer reporting requirements do not apply with respect to any sales that are exempt from reporting under section 6045, including securities held by exempt recipients and shares in money market funds. Therefore, a tax-advantaged retirement account custodian or trustee should not be considered an "applicable person" under the proposed regulations generally.

This commenter's recommendation assumes that securities distributed in kind from a tax-advantaged retirement account become covered securities upon the initiation of a transfer to a taxable account. Based upon the plain language of the statute, the Institute does not believe that such shares become covered securities upon distribution, absent further clarification by the IRS. Section 6045(g)(3) defines a "covered security" as any specified security acquired on or after the applicable date if such security (i) was acquired through a transaction in the account in which such security is held, or (ii) was transferred to such account from an account in which such security was a covered security, but only if the broker received a statement under section 6045A with respect to the transfer. The second clause clearly does not apply, as the shares are transferred from an account in which the securities were not covered. Therefore, the question is whether such shares are "acquired" when they are distributed from the tax-advantaged retirement account into a taxable account, thus becoming "covered securities" that are subject to cost basis reporting.[14] The IRS should clarify whether such an in-kind distribution is treated as an "acquisition" for these purposes.

If securities that are distributed in kind from a tax-advantaged retirement account become covered securities once transferred to a taxable account, the Institute strongly recommends that the transfer reporting requirements should not apply to such distributions, and that the account custodians or trustees should not be treated as applicable persons for such purposes. Because tax-advantaged retirement accounts are not subject to cost basis reporting under section 6045, the systems used to calculate and report cost basis will not include such accounts. Brokers do not calculate basis for these accounts today and otherwise do not have any reason to do so.[15] Programming to include such accounts in cost basis reporting systems will be difficult, costly and largely unnecessary; the only reason to do so, if the commenter's suggestion were implemented, would be to permit reporting to a receiving broker upon an in-kind distribution. These types of transactions occur very infrequently[16] and will not justify the cost of building the systems to track basis for exempt accounts.

Upon an in-kind distribution, the adjusted basis of any distributed shares generally is the fair market value of such shares on the date of distribution. For mutual fund shares, this value is readily available and easily ascertainable – the adjusted basis will equal the closing net asset value of the fund shares on that date. Unlike other types of transfers, there is no other relevant information of which the broker must have knowledge. If the broker is unsure as to the correct date of distribution, they could ask the custodian or trustee for such information. Because the receiving broker can easily determine the fair market value of the distributed shares, tax-advantaged retirement account custodians and trustees

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[14] Any subsequent shares acquired in the taxable account clearly would be subject to cost basis reporting.

[15] Even if transfer reporting statements are required for transfers of exempt accounts generally, as the proposed regulations currently provide, brokers still will not need to calculate or report basis for these accounts because such information is not required on transfer statements with respect to non-covered securities.

[16] We understand that most in-kind distributions do not move outside a fund's books. In other words, the taxpayer will take an in-kind distribution but will keep the taxable account with the same mutual fund. The Institute's members, who are both the transferring and receiving brokers in such situations, do not believe that basis should be provided by the transferring broker to the receiving broker. The commenter seems concerned about situations in which a taxpayer takes an in-kind distribution by transferring the shares from the mutual fund to another broker.

should not be required to build the systems to report cost basis for these accounts for such limited situations.[17] Therefore, the Institute strongly recommends that tax-advantaged retirement account custodians and trustees should not be treated as applicable persons required to provide basis information upon in-kind distributions from such retirement accounts.

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Should you have any questions or concerns, we would be happy to discuss these issues with you further. Please contact Keith Lawson (202/326-5832 or lawson@ici.org) or me (202/371-5432 or kgibian@ici.org) if we can provide any additional information.

Sincerely,

/s/ Karen L. Gibian

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[17] If IRA custodians and trustees are treated as applicable persons for these purposes, the mutual fund industry likely will not undertake the time or expense to build cost basis reporting systems for these accounts, when such information will be needed on a very limited basis. Rather, such information likely will be provided manually.