INVESTMENT
COMPANY
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By Electronic Delivery

January 13, 2011

The Honorable Michael Mundaca
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

RE: Final Regulations on Cost Basis Reporting – Average Cost as Broker Default Method

Dear Mr. Mundaca and Mr. Wilkins:

The Investment Company Institute[1] urges the Internal Revenue Service ("IRS") and Treasury Department to amend a broker-default rule in the final cost basis reporting regulations that is highly detrimental to mutual fund shareholders. This provision, as discussed below, was not included in the proposed regulations; consequently, the mutual fund industry, which is most affected by the rule, had no opportunity to comment on it. The outcome of this request will determine the default basis methods chosen by brokers and mutual funds with respect to fund shares. Because the default method decision is a cornerstone of the cost basis reporting implementation process, it is essential that the IRS and Treasury promptly announce their intentions regarding this issue.

Under the default rule provided by the final regulations, a taxpayer who holds shares in an account for which the broker's default method is average cost must elect a basis method immediately upon opening a new account or upon acquiring new covered securities in an existing account. If the taxpayer fails to make such an election, the taxpayer may change methods prospectively only, even if no redemptions have occurred. This provision thus eliminates a taxpayer's opportunity, when he redeems shares, to choose which basis method to use and, consequently, which shares to redeem.[2] This rule is

[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 $12.31 trillion and serve over 90 million shareholders.

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

detrimental to shareholders and directly contradicts other provisions of the regulations. Moreover, the rule makes it far less likely that brokers and funds will choose average cost as their default method.

Amending this default rule is of the utmost importance to the Institute and its members. We urge the IRS and Treasury Department to announce promptly that brokers and funds that choose average cost as their default method may allow their customers to select any other basis method for existing covered shares until the time of the first redemption from that account.[3]

Final Regulations

The final regulations provide that the basis of a taxpayer's mutual fund shares is determined in accordance with the broker's default method, unless the taxpayer notifies the broker that he elects another permitted method.[4] The regulations generally provide that a taxpayer may elect a basis determination method at any time, up until the settlement date for the sale or transfer of stock.[5] If a taxpayer wishes to use the average cost method for mutual fund shares, he must provide a written election to the broker.[6]

A taxpayer who makes an election to use average cost may revoke the election by the earlier of one year or the date of the first sale, transfer or disposition of that stock following the election.[7] The broker may extend the one-year period but not beyond the first sale, transfer or disposition of the stock.[8] A revocation applies to all stock that the taxpayer holds in the account that is identical to the shares of stock for which the taxpayer revokes the election.[9] After revocation, the taxpayer's basis in the shares of stock to which the revocation applies is the basis before averaging.[10]

In the absence of a revocation, a taxpayer may change from the average basis method at any time, and such change will apply prospectively.[11] The basis of each share of stock to which the change applies remains the same as the basis immediately before the change.[12]

[3] We have discussed this issue via telephone with attorneys from the IRS and Treasury Department. Notwithstanding the IRS attorneys' lack of enthusiasm for addressing our concerns, they suggested that we submit written comments for their consideration.

[4] Treas. Reg. § 1.1012-1(e)(2).

[5] Treas. Reg. § 1.1012-1(c)(8); Treas. Reg. § 1.1012-1(e)(9)(i).

[6] Treas. Reg. § 1.1012-1(e)(9)(i).

[7] Treas. Reg. § 1.1012-1(e)(9)(iii).

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] Treas. Reg. § 1.1012-1(e)(9)(iv).

[12] *Id.*

The final regulations described above all were included in the proposed regulations. On their own, they did not seem to present any problems. The proposed regulations did not clearly indicate that these rules would require taxpayers to use the broker's average cost default method, for all covered shares in the account, at the first redemption if the shareholder did not affirmatively choose a method (including average cost) prior to that redemption. Rather, the proposed regulations seemed quite clear that a taxpayer could choose a basis method, including average cost, at any time, until the settlement date for a sale, transfer or other disposition.

The final regulations, however, clarified several points and added an example that changed the meaning of the proposed regulations. In response to comments on the proposed regulations, the final regulations clarify that a taxpayer has not made an average cost election if the taxpayer fails to notify a broker of the taxpayer's basis determination method and basis is determined by the broker's default method.[13] The Preamble to the final regulations further clarifies that, if a shareholder has not made an affirmative election to use average cost, there is no election that can be revoked. Therefore, the preamble notes, if average cost is the broker's default method, the taxpayer may change from that method prospectively. Again, it was not entirely clear that this rule applied before a first redemption for which the average cost method could be used. The final regulations also include an example, however, which illustrates the operation of these rules.[14] The IRS has since confirmed to us that they intended this result.

The final regulations thus provide that if a taxpayer does not elect a basis method, and the broker chooses average cost as its default method, the taxpayer is required to use average cost for covered shares currently in the account. This is true even if the shareholder has not redeemed or transferred any shares. The taxpayer may choose another method only for shares subsequently purchased in the account. The shares in the account prior to the method choice lose their individual lot history and will retain the average cost of the account as their basis going forward.

Regulations are Detrimental to Shareholders

These provisions of the final regulations are disadvantageous to fund shareholders because they significantly reduce taxpayers' flexibility to choose basis methods. The theme of shareholder flexibility has permeated the Institute's comments and the regulation project itself. The final regulations, however, effectively penalize fund shareholders who do not decide to choose a basis method immediately upon acquiring new covered shares in existing accounts or upon opening a new account, if the broker has chosen average cost as its default method.

This rule denies taxpayers the choice of methods permitted by the statute. Instead, it effectively forces them to accept the broker's default method of average cost if they do not choose a basis method immediately. The IRS explicitly rejected comments asking for this very result with respect to all default

[13] Treas. Reg. § 1.1012-1(e)(9)(i).

[14] *See* Treas. Reg. § 1.1012-1(e)(9)(v), example 2.

methods. In the preamble to the proposed regulations, the IRS was quite clear that taxpayers may choose any permissible method, and that brokers must provide all methods to their customers. We see no policy rationale for treating average cost differently from other default methods.

We were told by the IRS that this rule was intended to help brokers, by allowing them to average basis information within an account and therefore not requiring the storage of individual lot history for extended periods of time. The mutual fund industry, however, did not ask for this rule.[15] If it had been included in the proposed regulations, we would have argued strongly that it be deleted. In our extensive conversations with fund companies, broker/dealers, and service providers, the consensus has been that funds and brokers likely will keep individual lot history for accounts, at least until the first redemption. This is true even if the broker chooses average cost as its default method or if the shareholder affirmatively elects average cost.[16] The cost of storage is minimal, and keeping and transferring detailed lot information will allow brokers and funds to provide good customer service, including flexibility in choosing basis methods, to their shareholders.[17] As the industry that this rule is intended to help, we strongly urge the IRS to make it elective.

Regulations are Contradictory

This rule plainly contradicts other provisions in the regulations. As discussed above, the regulations clearly state that a taxpayer adequately identifies stock to be sold by doing so at the time of sale, transfer, delivery, or distribution.[18] A taxpayer also may elect the average cost method at any time, effective for sales or other dispositions of stock occurring after the taxpayer notifies the custodian or agent.[19] Under these provisions, a taxpayer does not have to inform the broker of a basis method until the taxpayer decides to redeem or transfer shares from the account.

The rule regarding average cost as a default method, however, effectively requires taxpayers to make this decision when the account is opened, for new accounts, or upon the acquisition of new covered shares in an existing account. This rule directly contradicts other provisions in the final

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[15] The Institute represents the vast majority of the mutual fund industry. We also have been working closely with the primary service providers to the industry. To our knowledge, none of our members or the service providers has suggested that such a rule is necessary. In fact, the consensus is that this rule will cause significant customer servicing issues, including substantial confusion to customers wishing to choose a method at the time of a redemption.

[16] The final regulations provide that shareholders who affirmatively elect the average cost method may revoke that election up to the earlier of one year or the first redemption. Brokers, however, have the discretion to extend the revocation period beyond one year, though not beyond the first redemption. We understand that many brokers and funds intend to extend the revocation period until the first redemption, even though such event may not occur for several years.

[17] If a fund or broker feels that storage costs are indeed burdensome, they would have the option of requiring shareholders to use their average cost default method, as the rule is currently written.

[18] Specifically, an adequate identification is made no later than the earlier of the settlement date or the time for settlement required by Rule 15c6-1 under the Securities Exchange Act of 1934. Treas. Reg. § 1.1012-1(c)(8).

[19] Treas. Reg. § 1.1012-1(e)(9)(i).

regulations that permit shareholders flexibility in deciding which basis method to choose and when to do so. Again, we see no policy rationale for treating customers differently simply because the broker or fund has chosen average cost as its default method.

Regulations Limit Ability to Use Average Cost

This broker-default rule will severely limit brokers' and mutual funds' ability to use average cost as a default method. From a customer-servicing standpoint, it makes average cost more onerous than other methods because it requires additional communications with customers to ensure they fully understand the consequences of not choosing a method immediately. Thus, the final regulations likely will force brokers and funds to pick a default method other than average cost. This contradicts the plain language of the statute, which permits brokers and funds to choose any default method with respect to mutual fund shares.

In general, the fund industry would prefer to continue providing average cost to their customers. Mutual funds voluntarily have calculated average cost basis for the majority of fund shareholders for decades. Because of this history, funds and brokers have institutional knowledge and experience in providing average cost. Further, fund shareholders are accustomed to receiving this information. Brokers and funds, however, are unlikely to employ a method that will unduly harm their customers.

The IRS has suggested that brokers and funds could mitigate the effects of this rule by communicating with customers when accounts are opened or new covered shares are acquired in existing accounts. The IRS seems to believe that brokers and funds could simply inform their customers of their average cost default method and the consequences if the customer does not immediately choose another method. Although brokers and funds will do their best to inform customers of these rules, it is unrealistic to assume that such communications will solve the problem. Shareholders today are inundated with regulatory-related notices (*e.g.*, privacy notices, credit card term changes, prospectus changes), as well as unsolicited mail and e-mail. Thus, important shareholder communications may not be read or receive careful consideration. The industry's experience has shown that directed communications with customers, seeking some action by the customers, generate a very limited response rate. Therefore, brokers and funds are reluctant to rely upon this as a solution to the problems created by this rule. Absent a change to the average cost default rule, brokers and funds likely will choose a default method that does not have such negative ramifications for their customers.

Final Regulations Would Have Benefited from Stakeholder Dialogue

We appreciate the herculean efforts of the IRS and Treasury Department to complete the final regulations. Overall, we were happy to see that the government incorporated many of our comments. We feel, however, that the final regulations contain unnecessary deficiencies that could have been addressed earlier if the IRS had engaged stakeholders more fully in the process after the proposed regulations were issued.[20] The average cost issue raised in this letter, we believe, would not have arisen had the IRS and Treasury Department held continuing discussions with the mutual fund and broker/dealer industries, as we repeatedly offered.[21] This would have given the IRS and Treasury Department a more thorough understanding of the many factors impacting cost basis reporting and its implementation.

Instead, the government chose to rely solely upon written comments on the proposed regulations and declined to meet with stakeholders. Such written comments could not have contemplated all possible issues raised during the regulation project. The structure and operations of the mutual fund industry are extraordinarily complex, and implementing cost basis reporting is quite complicated. We could have better explained many of these intricacies to the IRS and Treasury if some manner of dialogue had been established. We have had such informal communications in the past on other fund-related tax issues, often with good results; we hope the IRS and Treasury Department will choose to do so going forward.

Requested Change

The rule regarding average cost as a default method is detrimental to fund shareholders, directly contradicts other provisions in the final regulations, and limits brokers and funds' ability to use average cost as a default method. A shareholder has flexibility in choosing a method, including the timing of that choice, if the broker's default method is first-in, first-out; the same rule should apply if the broker's default is average cost. The Institute thus urges the IRS and Treasury Department to provide that brokers and mutual funds may allow their customers to choose any method at any time for all fund shares in an account, until the first sale, transfer or disposition, even if the broker's default method is average cost.[22]

One possible solution would be to issue guidance clarifying that a broker is not required to apply its default method until the time of the first sale, transfer or disposition. This clarification would allow shareholders to choose another method at that time; if the shareholder does not specify a method, the broker's default of average cost would apply.[23] As discussed above, brokers and funds generally will maintain individual lot history for an account at least until the first redemption, even if the shareholder affirmatively elects average cost. Maintaining this history will allow brokers and funds to provide all methods to their customers upon a redemption or transfer. Therefore, most brokers and funds do not plan to lock themselves into average cost until a redemption or transfer has occurred.

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[20] We have raised other issues with the IRS and Treasury verbally.

[21] Other than the few questions posed at the public hearing on February 17, the government did not once contact us for any further elaboration or clarification on our written comments.

[22] Our request would not affect the existing rules regarding the revocation of an average cost election.

[23] If such a clarification were provided, example 2 in Treas. Reg. § 1.1012-1(e)(9)(v) should be stricken from the final regulations.

We understand that the guidance process is lengthy. Brokers and funds, however, currently have less than one year to implement the final regulations. As discussed above, the outcome of this request will determine the default basis method chosen by brokers and funds for fund shares. That decision must be made first, in order to fully implement the final rules. Brokers and funds have multiple systems (both proprietary and vendor-supplied) that will require programming changes in order to support the elected default method and basis options available to shareholders. These systems support basis calculations, transaction processing (through multiple interfaces), transfer reporting, transaction confirmations and shareholder statements, and Form 1099 reporting processes. The development of shareholder communications regarding the new reporting requirements, including the broker's default method, also is critical to a successful transition for the industry.

Given the urgent need for a solution to this problem, we urge the IRS and Treasury Department to issue guidance on this issue as soon as possible. We also recommend that the IRS issue some form of interim guidance indicating its intent with respect to this question, if it is not able to come to a solution within a reasonable time. This would permit brokers and mutual funds to make decisions regarding default methods without having to wait for more formal guidance.

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We appreciate your prompt attention to this matter. If we can provide you with any additional information, please contact me at (202) 371-5432 or kgibian@ici.org.

Sincerely,

/s/ Karen L. Gibian

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Associate Counsel – Tax Law

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