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*By Electronic Delivery*

February 8, 2010

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

RE: Comments on Proposed Regulations on Cost Basis Reporting (IRS REG-101896-09)

Dear Mr. Wilkins:

The Investment Company Institute<sup>1</sup> appreciates this opportunity to provide the Internal Revenue Service (the “IRS”) and the Treasury Department with our comments on the proposed regulations on cost basis reporting, which were released on December 16, 2009. We were encouraged to see that the IRS incorporated many of our suggestions,<sup>2</sup> including recommendations that the IRS leave certain decisions as to communications methods and record formats to the industry to decide. Overall, we feel the IRS addressed many of the relevant issues with rules that are logical and workable.

There remain some areas, however, where calculation and reporting issues persist, and further clarification is needed from the government. We discuss these issues below. Of these, the most pressing concerns for the mutual fund industry are:

- Average Cost. The Institute believes that the IRS should eliminate the requirement that average cost elections be made in writing. We also feel that shareholders should be permitted to switch easily from average cost to another method.
- Gifted and Inherited Shares. The Institute strongly feels that Congress did not intend for these shares to be covered by the basis reporting rules. If the IRS insists that they are

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<sup>1</sup> 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 \$11.82 trillion and serve almost 90 million shareholders.

<sup>2</sup> See the Institute’s letter to Clarissa C. Potter, dated April 9, 2009, regarding comments on Notice 2009-17 (the “2009 Institute letter”).

covered, the default rules in the proposed regulations must be made more administrable.

- Flexibility for Transfer Statements. Brokers should have maximum flexibility with respect to transfer statements, including the information required on such statements.
- February 15 Reporting Deadline. The extended deadline should apply, as Congress intended, to *any* form that brokers send to mutual fund shareholders.

We also will discuss these issues at the public hearing on February 17.

Given the short time frame before the cost basis reporting requirements become effective, the Institute urges the IRS and Treasury Department to issue final regulations on these issues quickly. Implementation of the new requirements will take significant time to build and program the necessary systems, to test the systems to ensure they are functioning properly, and to communicate with customers about basis calculation methods. The mutual fund industry has been working on these issues since the legislation was enacted in 2008 and has made significant progress in many respects; however, they cannot begin the lions' share of the work until regulations have been finalized.

## **I. Form and Manner of Reporting Requirements**

### **A. Draft Form 1099**

The Institute commends the IRS for releasing a draft Form 1099-B along with the proposed regulations. Overall, we believe the draft form conveys the necessary information in a reasonable format. We are not concerned about the possibility of providing multiple forms for one redemption (*e.g.*, the redeemed shares include long-term, short-term, and non-covered shares) because, in most cases, mutual funds and brokers provide tax reporting information on substitute statements.

Given the correlation between the Form 1099-B and the Schedule D, we ask that the IRS issue a draft Schedule D so the public may provide comments. It would be useful for the industry to see what information their shareholders must provide to the IRS regarding their shares and how such information is reported. This would help us better understand how the information we provide will be used by our customers, which would be valuable in determining what information should be provided on the Form 1099-B and how such information should be presented. We note that the Schedule D should include some way for the shareholder to indicate that the basis number they are using differs from that provided by the broker, for those situations in which the shareholder has applied a basis adjustment rule that the broker was not required to apply (*e.g.*, for wash sales or other transactions occurring outside an account).

The Institute and its members do have questions regarding brokers' responsibility with respect to reporting gain or loss on the Form 1099-B. Section 6045(g) and the proposed regulations only require brokers to report whether a taxpayer's gain or loss is short-term or long-term, but not the

amount of such gain or loss. The draft Form 1099-B, however, requires brokers to report the amount of the shareholder's gain or loss (box 7). It is not clear whether brokers must take other rules into account when reporting the holding period and amount of shareholders' gain or loss.<sup>3</sup> We have specific questions regarding the application of the wash sale and six-month conversion rules (discussed below); in general, however, the IRS should clarify which rules brokers must apply when reporting gain or loss on the Form 1099-B.

### **1. Wash Sales**

Brokers must report on the Form 1099-B the amount of loss disallowed due to a wash sale, but the proposed regulations do not address whether brokers also must adjust the reported amount of gain or loss to take the disallowed loss into account. If brokers are required to adjust the amount of gain or loss on the Form 1099-B, then the Schedule D must be clear as to which information the shareholder must use. Confusion and double-counting may arise if the broker reports both the disallowed loss and an adjusted amount of gain or loss that takes the disallowed loss into account; the concern is that, absent clear, specific instructions on the Schedule D, the shareholder might adjust the gain or loss twice.

For example, assume a shareholder redeems 100 shares of Fund A with a total cost basis of \$1200. The fair market value of the shares at the time of the redemption is \$1000. Also, the shareholder had a wash sale within the account that results in a disallowed loss of \$100. For purposes of the Form 1099-B, the broker will report \$1000 of gross proceeds (box 2), \$1200 of cost basis (box 3), and a disallowed loss of \$100 (box 5).

The question is what amount of gain or loss the broker should report (box 7). The reported loss would be \$200 without taking the disallowed loss into account; if the broker adjusts the loss for the wash sale, then the reported amount would be \$100. The proposed regulations and draft Form 1099-B do not specify whether brokers must make this adjustment. If the broker reports in box 7 an adjusted gain or loss of \$100, we are concerned that a shareholder may apply the disallowed loss reported in box 5 and adjust the amount of loss in box 7 again on the Schedule D, resulting in zero loss. Therefore, we ask the IRS to clarify whether brokers should adjust the amount of gain or loss in box 7 for a disallowed loss due to wash sales, and if so, the IRS should amend the Schedule D to make it clear that the shareholder should not reapply the amount of disallowed loss in box 5.<sup>4</sup>

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<sup>3</sup> It would be helpful if the IRS would release draft instructions for the Form 1099-B as well.

<sup>4</sup> Many mutual funds that already provide average cost information to their shareholders on a voluntary basis are taking wash sales into account. Of these funds, a substantial number adjust the amount of gain or loss reported to the shareholder for the amount of loss disallowed due to the wash sale. It would be easier, from a systems perspective, if these funds could continue to adjust the amount of gain or loss, rather than requiring them to deprogram their systems to no longer do this calculation.

## 2. Six-Month Conversion Rules

Section 852(b)(4) provides rules affecting a shareholder's loss on the sale or exchange of stock held six months or less. Section 852(b)(4)(A) provides that if a shareholder receives a capital gain dividend with respect to regulated investment company ("RIC") shares, and the shareholder holds those shares for six months or less, then any loss from the sale of those shares will be treated as a long-term capital loss, rather than short-term, to the extent of the capital gain dividend. Similarly, section 852(b)(4)(B) provides that if a shareholder receives an exempt-interest dividend with respect to RIC shares which the shareholder holds for six months or less, any loss on the sale or exchange of those shares is disallowed, to the extent of the tax-exempt dividend. The purpose of these rules is to prevent a taxpayer from buying into a fund shortly before a tax-favored dividend (such as one attributable to capital gains) is paid and then selling shortly thereafter in order to realize a short-term capital loss attributable to the drop in net asset value ("NAV") arising from the dividend paid.

Although the rules of section 852(b)(4) are not basis adjustment rules, they do affect the amount and character of a taxpayer's gain or loss. The proposed regulations, however, do not address them. It is not apparent from the statute whether brokers should apply these rules. Section 6045(g)(2)(A) provides that brokers must report to shareholders and the IRS whether any gain or loss with respect to a covered security is long-term or short-term, within the meaning of section 1222. Section 852(b)(4)(A) appears to apply *after* the application of section 1222; therefore, it is not clear whether brokers should adjust the holding period of reported gain or loss for this rule. Section 852(b)(4)(B) may cause some amount of a reported gain or loss to be disallowed, and therefore may affect the amount of gain or loss reported in box 7. Because the tax-exempt dividend rule does not affect basis or holding period, however, it does not appear to fall within the scope of the basis reporting requirements. Therefore, we ask the IRS to clarify whether brokers must adjust the amount of gain or loss on the Form 1099-B for any loss conversions under section 852(b)(4).<sup>5</sup>

We also ask the IRS to exercise its regulatory authority under section 852(b)(4)(E) to shorten the required holding period with respect to tax-exempt dividends in section 852(b)(4)(B). The statute permits the IRS to apply this rule on the basis of a holding period requirement shorter than six months, but not shorter than the greater of 31 days or the period between the regular distributions of exempt-interest dividends, for RICs that regularly distribute at least 90 percent of their net tax-exempt interest. Many tax-exempt bond funds declare dividends on a daily basis but pay on a monthly basis. For these funds, the six-month conversion rule makes no sense. Because the net amount of tax-exempt interest received by a daily-declaration fund is declared as a dividend each day, that income is not includible in the fund's NAV. Hence, any decline in the NAV of a daily-declaration fund is attributable to a real economic loss and not to a periodic payment of a dividend. Regulations that decrease the holding period to 31 days will reduce significantly the number of loss conversions that occur, though they will not completely correct the problem. If the IRS determines that brokers must take the six-month

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<sup>5</sup> As with wash sales occurring outside an account, if the broker is not required to take these rules into account for reporting purposes, the shareholder still would have an obligation to apply them.

conversion rules into account for reporting purposes, reducing the holding period to 31 days will limit brokers' requirement to track the holding period of individual lots.

## **B. Corrected Forms 1099**

The Institute recommended in its 2009 letter that the IRS provide a *de minimis* rule for amended Forms 1099 as well as a cut-off date after which such amendments need not be made.<sup>6</sup> The IRS did not take these suggestions.<sup>7</sup> Given the increased amount of information that must be reported on Form 1099-B, we reiterate our original recommendation. Under the new reporting regime, there likely will be a significant increase in the number of corrected Forms 1099-B. There are many reasons why a basis number and the amount of gain or loss upon a redemption might be corrected, including corrected transfer statements and information statements from issuers. Because there is no time limit for sending amendments, corrected statements could occur months or even years after the original Form 1099-B was sent.

These amended Forms 1099 can impose significant burdens and costs on brokers and investors, as well as the IRS, which must process all of the corrections. The Institute believes that in many cases the cost of sending and processing the amendments far outweighs any additional tax revenues received by the government. Therefore, we recommend that the IRS provide a *de minimis* rule, pursuant to which a broker is not required to amend a customer's Form 1099 if the aggregate adjustment from the income initially reported (or the basis, in the case of gross proceeds reporting) is \$10 or less. This suggestion is consistent with current rules that exempt payors from filing information returns for dividends and interest totaling less than \$10.<sup>8</sup> We also note that the regulations under section 6045 already provide an exception for gross proceeds reporting with respect to a sale of a fractional share of stock if the gross proceeds on the sale of the fractional share are less than \$20.<sup>9</sup>

The Institute also recommends that the IRS provide a cut-off date for amending tax information from prior calendar years.<sup>10</sup> As noted above, due to the open-ended requirement to correct transfer statements and information statements from issuers, corrections could occur months or years

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<sup>6</sup> See 2009 Institute letter, p. 27.

<sup>7</sup> To decrease the number of corrected Forms 1099s, the Institute also suggested that the IRS amend the regulations regarding returns of capital. Specifically, the Institute recommended that the regulations provide that brokers need only apply returns of capital to those distributions made during the portion of a fund's taxable year occurring in the current calendar year; this would alleviate any need to amend returns for distributions made during the prior calendar year. The IRS did not take this suggestion, but this change is included in the Regulated Investment Company Modernization Act of 2009 (the "RIC Modernization Act") (H.R. 4337), which was introduced in the U.S. House of Representatives on December 16, 2009. The Institute strongly supports this bill.

<sup>8</sup> See sections 6042(a)(1) (returns regarding payments of dividends) and 6049(a) (returns regarding payments of interest).

<sup>9</sup> Treas. Reg. § 1.6045-1(c)(3)(ix).

<sup>10</sup> An exception could be made for substantial errors.

after a Form 1099-B has been filed. At some point, the value of providing corrected information to shareholders and the IRS is far outweighed by the costs and burdens on brokers, investors and the government. At the very least, we ask the IRS to confirm that brokers need not send corrections for returns filed more than three years before (four years for payments subject to backup withholding), as specified in Rev. Proc. 2009-30 (as reprinted in Publication 1220).

## II. Calculation of Basis

### A. Selection of Basis Method and Broker Default Methods

The Institute is pleased that the proposed regulations do not specify the manner or time in which brokers must communicate their default method to their customers, or how customers must communicate their selected basis method to their brokers (if choosing FIFO or another form of specific identification). As noted in our 2009 comment letter, different firms may wish to utilize different means of communicating with their customers, as the best method for each firm and/or customer will vary.

We note that the proposed regulations provide that a broker must use the basis method selected by the *taxpayer*. We believe this requirement should be amended to provide expressly that the selection may be made by an agent of the taxpayer (for both specific identification of lots and an election to use average cost). For example, a taxpayer may have a managed account with an investment adviser or asset manager; the investment adviser or asset manager typically has the authority to sell shares in that account without consulting the taxpayer on each trade. In such cases, an agent of the taxpayer should be permitted to choose a basis method or identify specific lots on behalf of the taxpayer.

The Institute also welcomes the rule which states that standing orders will be treated as an adequate identification of stock, as requested in our 2009 letter. We ask for clarification, however, that brokers are not *required* to accept standing orders, but may do so at their discretion. The industry's concern is that, while it is possible to program for basic formulaic instructions (*e.g.*, highest in, first out; last in, first out), it is not feasible to anticipate every possible combination that shareholders could devise. Therefore, brokers should have the discretion to accept a customer's standing order or to require the customer to make a specific identification at the time of each redemption.

The proposed regulations do not amend the current rule in Treas. Reg. § 1.1012-1(c)(3)(i)(b) and (ii)(b), which requires a broker or agent to provide written confirmation of the sale of stock a taxpayer has specifically identified within a reasonable time after sale. The Institute recommended in our 2009 letter that this rule be eliminated, as it is unnecessary for shares subject to the new cost basis reporting requirements.<sup>11</sup> The primary purpose of the confirmation rule is to provide proof that a shareholder has complied with the contemporaneous identification requirement in the regulations if the shareholder chooses to specifically identify lots. Under the new cost basis reporting regime, the

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<sup>11</sup> See 2009 Institute letter, p. 9.

broker must use the cost basis method selected by the shareholder (including specific identification), and the shareholder must then use the cost basis number provided by the broker on the Form 1099-B.<sup>12</sup> As we originally argued, the Form 1099-B effectively will provide confirmation by the broker that the specific identification requirements were met.<sup>13</sup> Therefore, the written confirmation requirement is no longer necessary. If the IRS insists that this requirement remain in place, we ask that the proposed regulations not require brokers to send confirmations for standing orders. In these cases, the broker already will have in its file the shareholder's standing order, and there is no need to reconfirm this order at every redemption.

Finally, the Institute notes that the proposed regulations, as currently written, seem to preclude brokers from choosing a default method other than FIFO. Prop. Reg. § 1.6045-1(d)(2)(ii) states that in the case of a sale of securities acquired on different dates or at different prices but involving less than the entire position of the security held in an account, a broker must report the sale on a FIFO basis, unless the customer notifies the broker by means of making an adequate and timely identification of the securities to be sold. Thus, this regulation appears to require brokers to use FIFO as their default method for *all* securities. Prop. Reg. § 1.6045-1(d)(6)(v) states, however, that for securities for which basis may be determined by the average basis method, a broker must compute basis using the average basis method if the owner validly elects that method for the securities sold or, in the absence of any instruction from the customer, if the broker chooses that method as its default basis determination method. These two provisions appear to be inconsistent and should be reconciled to make it clear that brokers may choose any default method with respect to shares in a RIC, as the statute provides.

## **B. Definition of Account**

The Institute supports the IRS's view that a definition of account is not needed; we agree that the better approach is to specify when shares must be treated as held in separate accounts. The mutual fund industry believes the statute and the proposed regulations achieve the intended result and provide sufficient information for us to determine how to apply the cost basis reporting rules. We understand, however, that other commentators may encourage the IRS to define an account for their unique purposes. We stress that not all such clarifications are applicable to or needed by other brokers. Therefore, while we encourage the IRS to provide clarification as needed, we ask you to refrain from defining accounts generally. Maximum flexibility is needed to address the various account arrangements and business practices that exist today across the financial services industry, and we feel strongly that the proposed regulations provide such flexibility.

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<sup>12</sup> The shareholder, as noted in footnote 5 above, still would need to apply any cost basis adjustment rule that the broker was not required to apply (such as when a wash sale occurred in different accounts).

<sup>13</sup> Some brokers, however, may wish to continue providing confirmation to shareholders at the time of redemption as a business practice and customer service accommodation to avoid any confusion later on.

## **C. Adjustments for Transactions Occurring Inside the Account**

### **1. Wash Sales**

The Institute recommended in our 2009 letter that the IRS adopt a *de minimis* exception to the wash sale rule of section 1091.<sup>14</sup> We believe that, without such an exception, brokers may have to send amended Forms 1099 if such forms are sent to shareholders before brokers are able to perform their “wash sale runs.” Although the extension of the February 15 reporting deadline should decrease some of these amendments, it will not eliminate all. This is especially true if a fund is providing information to an intermediary sometime in January so that the intermediary can include it with other information compiled for a customer. Therefore, we reiterate our recommendation, and ask that the IRS give brokers the option not to apply the wash sale rule to correct Forms 1099 for loss disallowances of \$10 or less arising from share purchases occurring after December 31 that affect the cost basis of shares sold before January 1 (and within 30 days of the purchase).

### **2. Sales Load Basis Deferral Rule**

As explained in our 2009 letter,<sup>15</sup> the open-ended nature of the sales load basis deferral rule of section 852(f) can result in amended Forms 1099 months or years after the original forms are sent. The proposed regulations provide that if a shareholder buys and then sells shares in one account, followed by the purchase of shares in another account pursuant to a reinvestment right, then the broker is not required to apply section 852(f) for reporting purposes.<sup>16</sup>

It is not clear, however, when a shareholder is treated as exercising a reinvestment right in a separate account. Although we generally do not believe the IRS should define an account for purposes of the cost basis reporting rules, we do believe some clarity is needed here. Therefore, we ask the IRS to clarify that brokers are not required to apply section 852(f) in circumstances where a shareholder exercises the reinvestment right with respect to securities with a different Committee on Uniform Security Identification Procedures (“CUSIP”) number. This would be consistent with the rule on wash sales in the proposed regulations.

Even with this clarification, an issue still may arise if a shareholder utilizes a reinvestment right with respect to securities with the same CUSIP. For example, a shareholder purchases shares in Fund A, then sells those shares within 90 days and purchases shares in a money market fund (for which no sales charge is imposed). Several years thereafter, the shareholder redeems the money market fund shares and reinvests in Fund A without incurring an additional sales charge. This transaction clearly is not the type for which the sales load basis rule was crafted. Nevertheless, it is not clear under the

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<sup>14</sup> See 2009 Institute letter, p. 16.

<sup>15</sup> *Id.*, p. 15.

<sup>16</sup> See Prop. Reg. § 1.6045-1(d)(6)(vi), example 6.



proposed regulations whether brokers must retroactively recalculate the gain or loss on the original Fund A shares.

The RIC Modernization Act provides a solution to this issue. The bill limits the rule's application to cases in which a taxpayer makes a reinvestment triggering the rule by January 31 of the calendar year following the year in which the redemption of the initial investment occurred. This change will reduce the likelihood that a broker will have to send an amended Form 1099-B because of the sales load basis deferral rule. The Institute strongly supports the RIC Modernization Act. If this bill is not enacted, however, this problem still will exist. Therefore, if this problem is not solved legislatively, we reiterate our initial recommendation that the IRS issue guidance providing that, for cost basis reporting purposes, brokers need not apply the sales load basis deferral rule if the shareholder does not exercise a reinvestment right by January 31 of the calendar year following the calendar year in which the shareholder disposed of the first-acquired shares. As with wash sales occurring outside an account, the shareholder still would have an obligation to apply the rule under section 852(f), regardless of when the reinvestment right is exercised.

#### **D. Elimination of Double-Category Average Cost Method**

The Institute recommended that the IRS eliminate the double-category method, and we welcome this change to the current rules. We are unaware of any fund company that currently applies the double-category method when voluntarily providing cost basis to its shareholders. Therefore, we do not see any need for continuing to permit this alternative basis calculation method.

#### **E. Average Cost**

##### **1. Shareholder Election**

The proposed regulations require a taxpayer to make the average cost election in writing. The Institute believes that this requirement is unnecessary and asks that the IRS eliminate this rule. The mutual fund industry would prefer to have maximum flexibility, as with other basis method selections, when determining how to communicate with their shareholders.

Requiring shareholders to inform their broker in writing that they wish to use average cost creates a number of customer service and implementation issues. For new customers, getting this election in writing may be straightforward; the fund simply could ask the shareholder to make the choice at the time of the account opening. Situations may arise, however, in which the shareholder will need to make a new election, and requiring that election in writing will be impracticable. For example, a shareholder may call a broker and ask to exchange shares from one fund to another. Because the shares exchanged or purchased in the new fund would constitute a new account for basis reporting purposes, the proposed regulations would require the shareholder to provide the fund with a new election in writing if he or she wishes to continue using average cost.

For existing customers, this requirement becomes more impracticable. A broker would need to receive a written election from all its customers for any shares acquired after December 31, 2011, even if the broker believes the shareholder has used average cost in the past.<sup>17</sup> This new requirement will be confusing for shareholders and difficult to implement for funds. If a shareholder, who has not yet made a redemption of post-effective date shares, calls his or her broker and asks to redeem a portion of his or her account using average cost, the broker will not be able to fulfill that request until the shareholder provides the average cost election in writing. This will result in some amount of delay before the shares can be redeemed; in a declining market, this delay could result in a loss of share value to the customer. This problem easily would be solved if the broker could accept any shareholder basis method election over the phone. Under the proposed regulations, a broker could accept the shareholder's basis method election over the phone if the shareholder chose any method *but* average cost.

Further, it is not clear how the writing requirement interacts with the broker default method. Brokers have the ability to choose any default method with respect to RIC shares.<sup>18</sup> If the shareholder must elect average cost in writing, however, it does not appear that a broker could use average cost as its default method. We do not believe this was Congress' intent. As we discussed in our 2009 letter, the mutual fund industry has been providing average cost basis information to a substantial number of customers on a voluntary basis for many years, and we believe that a significant number of shareholders receiving such information are using it. Many brokers may wish to continue using average cost as their default method, but the writing requirement may limit their ability to do so.

We believe the IRS may have required the average cost election in writing because once a shareholder has made a redemption, it may be difficult to change methods, and the shareholder potentially could be harmed by the requirement that all shares left in the account must use the average basis going forward. The Institute and its members believe, however, that this is a customer relations issue that can be resolved by each company. We trust that brokers will have significant time in which to communicate with their shareholders to ensure that their customers' wishes are met.

If the IRS insists that the average cost election be made in writing, the Institute asks that the IRS clarify that an electronic notification qualifies as such for this purpose. Allowing electronic communications from the shareholder would simplify the election process greatly. We also ask that the proposed regulations permit brokers to assume negative consent from shareholders if average cost is the broker's default method. Under the proposed regulations, if a broker chooses average cost as its default method, but the shareholder does not agree to that method in writing, the broker would not be able to use that default method. Permitting negative consent would allow the broker to decide, as a customer service matter, whether to use negative consent to effectively require a shareholder to use average cost until the shareholder affirmatively elects another method. Further, shareholders should be permitted

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<sup>17</sup> Although many funds have been providing average cost basis information to a substantial number of shareholders on a voluntary basis for many years, a fund will have no way of knowing whether its shareholders have used average cost.

<sup>18</sup> As discussed above, the proposed regulations actually may not permit brokers to choose any default method with respect to RIC shares, as the statute provides. The regulations should correct this inconsistency.

to make a complex-wide election; in other words, a shareholder should be able to make a single written election that applies to all accounts with that broker, including accounts opened in the future (unless the shareholder specifically chooses a different method for each account).

## **2. Revocation of Election**

The proposed regulations provide that a taxpayer may revoke an average cost election by the earlier of one year after making the election or the first redemption from the account for which average cost was elected. The proposed regulations also provide that brokers may extend the one-year period, but not beyond the date of the first redemption. Although many funds may choose to extend the revocation period for their shareholders beyond one year, the Institute agrees that the revocation period should end at the date of first redemption, and no change is needed to the proposed rule.

If the IRS eliminates the requirement that taxpayers elect average cost in writing, as the Institute requests above, we ask that the revocation period begin when either the taxpayer makes an affirmative average cost election or the broker notifies the taxpayer that the broker's default basis method is average cost.

The Institute also asks that the IRS provide some leniency in the first few years following the effective date for RIC shares.<sup>19</sup> Given the difficulty that brokers and the IRS will face in educating shareholders as to the new reporting requirements (and the corresponding need to make basis method elections at the time of redemption), there may be a higher number of corrections to information statements in the early years.

## **3. Change from Average Cost Method**

The proposed regulations provide that, once a taxpayer has made a redemption of post-effective date shares and reported basis using the average cost method, the taxpayer may change from the average cost method to another method (prospectively only), but such change is a change in method of accounting to which the provisions of sections 446 and 481 apply.<sup>20</sup> Therefore, a taxpayer may change its basis determination method by obtaining the consent of the Commissioner under applicable administrative procedures. As originally suggested in our 2009 letter,<sup>21</sup> the Institute asks the IRS to eliminate the requirement that taxpayers seek the Commissioner's consent before switching from the average cost method. As we previously noted, a shareholder effectively could revoke an average cost election for future share purchases by opening another account with the broker. Further, requiring consent from the Commissioner can be a confusing and time-consuming process, and the average

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<sup>19</sup> The need for transition relief is discussed in more detail below.

<sup>20</sup> We submit that neither section 446 nor section 481 need apply. The only impact of a change from computing basis using average cost is that all previously purchased shares would have the same basis, and the basis for all shares acquired thereafter would be determined, individually, as of the acquisition date.

<sup>21</sup> See 2009 Institute letter, p. 20.

mutual fund shareholder likely will not understand why or how they must request this consent. This process may discourage taxpayers and could have the result of effectively locking most taxpayers into average cost for the life of the account. As a result, some fund companies may be reluctant to adopt average cost as a default method. From a customer service standpoint, the mutual fund industry feels strongly that shareholders should have the ability to choose other methods, and that such changes should be relatively straightforward and taxpayer-friendly.

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

If a change from average cost is a change in method of accounting, then taxpayers should have an obligation to inform their broker, through any reasonable means, that they are changing from average cost to another method. Brokers only should be required to retain and report basis information, using a method other than average cost, after it receives such notification, and then only for any shares acquired after such notification. In other words, if a shareholder has told his broker that he wishes to use average cost, and a redemption has been made or the revocation period has elapsed, the broker should not be required to track basis in the account using any other method until the shareholder informs the broker that he or she will use another method going forward. If the shareholder does not have such an obligation to notify the broker, the broker will have no other way of knowing that the shareholder no longer plans to use average cost.

#### **4. Single-Account Election**

The Institute asks for clarification on several points relating to the single-account election. First, it is not clear how the broker election interacts with the shareholder's average cost election.<sup>22</sup> The proposed regulations state that the single-account election is irrevocable; the regulations also provide that a shareholder may revoke the average cost election by the earlier of one year or the first redemption. The proposed regulations should clarify whether a shareholder's revocation of average cost also revokes the single account election. Also, if a shareholder has redeemed covered securities using average cost but later is granted permission by the Commissioner to change basis methods, the proposed regulations should specify how such change in method affects the single-account election. A similar issue arises if a shareholder transfers the now-single account to another broker and chooses another basis method for the new account.

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<sup>22</sup> We note that, although the statute provides that the single-account election is made by the broker, in reality it will become a shareholder election. Because the broker in most cases will not know whether a shareholder has been using average cost for pre-effective date shares, the broker will need to communicate with the shareholder to determine whether the single-account election can be used. If a shareholder has not been using average cost or does not wish to combine the accounts, the broker will not make the election.

In these situations, if a shareholder revocation or change in method is permitted, or if the shareholder transfers the account to another broker, the proposed regulations should clarify that the pre-effective date shares remain “covered” because of the single-account election. Once a broker has made the single-account election, the broker will roll up the lot history of the pre-effective and post-effective date shares (at least for shares held more than five years) into one account, with one average cost. If the shareholder revokes the average cost election or changes to another method, the broker may not be able to go back and reconstruct that history or determine which shares previously were non-covered securities. If the account is transferred to another broker, the new broker similarly will not have the individual lot history. Therefore, any shares in the account that were part of the single-account election should remain covered for basis reporting purposes, with a basis equal to the average cost of the account before the revocation or method change.

Second, we ask the IRS to eliminate the accuracy requirement for the single account election. The proposed regulations provide that a broker may make the election only for the shares of stock for which the broker has “accurate” basis information. A broker has accurate basis information if the broker neither knows, nor has reason to know, that such information is inaccurate. Our concern with the “reason to know” standard is that funds have been providing average cost to their shareholders for many years on a voluntary basis and may not have applied in all cases with great precision every possible adjustment to cost basis (particularly in the early years of reporting).<sup>23</sup> Because cost basis reporting was not required, there were no requirements or guidelines as to which basis adjustment rules funds were to apply. We understand, for example, that most firms who provided average cost applied the wash sale rule in most cases, but even the funds themselves may not know that they applied every possible rule correctly with respect to every shareholder. Similar concerns may arise if a fund allowed a customer to provide supplemental information regarding the cost basis of some shares. In any event, the cost basis information that a fund has calculated voluntarily on pre-effective date shares generally will be more accurate than that otherwise reported by a shareholder. Given the uncertainty as to whether this information for pre-effective date shares satisfies the accuracy requirement, however, funds may be reluctant to make the single account election. The accuracy requirement thus may discourage brokers from providing what may be the most accurate basis information that is available on the pre-effective date shares. Therefore, we urge the IRS to eliminate the accuracy requirement and allow funds in all cases to use the data that they've been maintaining for pre-effective date shares.

Finally, the Institute asks the IRS to clarify that brokers may, at their discretion, use shareholder-provided information for pre-effective date shares for purposes of the single-account election. There may be situations in which a shareholder has basis information for pre-effective date shares for which the broker does not.<sup>24</sup> The shareholder may wish to combine both accounts into a

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<sup>23</sup> We note that some of the adjustments may not be required under the proposed regulations.

<sup>24</sup> There are a number of reasons why a broker may not have basis information for pre-effective date shares. For example, the shares may have been transferred into the account from another broker, or the broker may have changed service providers, at which point historic basis information may have been lost.

single account for basis reporting purposes.<sup>25</sup> Because the single-account election is made by the broker, however, and because the broker did not calculate basis information for the pre-effective date shares, it is not clear that the broker is permitted to make the election under the proposed regulations.

Despite the lack of first-hand information regarding basis, the broker may wish to combine the two accounts, as a customer service. Further, it would simplify shareholder record keeping and benefit the IRS to receive this information. Therefore, we believe the proposed regulations should permit brokers to accept shareholder-provided information (with appropriate penalty relief) in these situations.

#### **F. Dividend Reinvestment Plans**

In general, the Institute does not have any comments on the proposed regulations regarding dividend reinvestment plans (“DRIPs”). Our understanding is that these rules do not apply to RIC shares, because RICs already are able to use average cost.<sup>26</sup> Because the proposed regulations are not entirely clear, however, we ask the IRS to amend the definition of DRIPs to specify that it does not apply to dividends reinvested in a RIC.

Further, other than the specific comments on the proposed regulations discussed in this letter, the mutual fund industry feels that the proposed regulations provide us with clear, workable rules on computing basis using average cost and reporting basis information to our shareholders. To the extent that further clarification to the average cost or other rules are needed to address DRIP-specific issues, we ask that the IRS limit those rules to DRIPs, rather than applying them broadly to any shares for which average cost is available.

### **III. Reporting to S Corporations**

The preamble to the proposed regulations indicates that the IRS is considering changes to the Form W-9 in connection with the new rule that S corporations are no longer exempt recipients for purposes of section 6045. As requested in our 2009 comment letter,<sup>27</sup> the Institute urges the IRS to promptly amend Form W-9 to provide an additional box where a shareholder can identify itself as an S corporation. Given the new reporting requirement, many funds will wish to determine when an account is opened whether the customer is an S corporation, and amending the form to permit such self-identification, under penalties of perjury, will assist funds greatly. This will minimize the number

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<sup>25</sup> The shareholder may have been computing average cost for the account on his or her own, even though the broker has not been providing that information to the customer. We understand that programs such as *Quicken* will perform this calculation.

<sup>26</sup> Prop. Reg. § 1.1012-1(e)(1)(i) states that a taxpayer may use average cost if the taxpayer leaves shares of stock in a RIC (as defined in Prop. Reg. § 1.1012-1(e)(5)) or shares of stock acquired after December 31, 2010, in connection with a DRIP (as defined in Prop. Reg. § 1.1012-1(e)(6)).

<sup>27</sup> See 2009 Institute letter, p. 30.

of corporate clients whose status as an S corporation or C corporation will need to be determined. Further, as the proposed regulations require that any corporation not known to be a C corporation must be treated as an S corporation, providing a mechanism for clear identification on the Form W-9 should reduce unnecessary reporting to C corporations and the IRS.

One consequence of this change to the reporting requirements is that S corporations now may be subject to backup withholding on gross proceeds (but not on other types of payments). Although this is not addressed in the proposed regulations, eliminating S corporations from the list of exempt recipients under section 6045 effectively would have this result. The Institute asks that the IRS clarify whether this was their intent.

#### **IV. February 15 Reporting Deadline**

The Institute and its members are concerned that the definition of “consolidated reporting statement,” for purposes of the February 15 reporting deadline, is administratively infeasible and inconsistent with Congressional intent. We strongly urge the IRS to modify the definition so that the February 15 reporting deadline applies to all tax information statements sent by funds and brokers to their clients.

The Institute and the Securities Industry and Financial Markets Association (“SIFMA”) expressed substantial concerns, throughout the legislative process, that funds and brokers would not be able to meet their new cost basis reporting responsibilities efficiently and effectively unless the tax reporting deadline were moved to February 15.<sup>28</sup> Extending the deadline had been an important priority for both groups and their members for many years because of the benefits that arise for investors and the IRS when the number of tax information returns that must be amended is reduced. The January 31 deadline simply was not providing funds and brokers with sufficient time to ensure the completeness and accuracy of tax information sent to customers. The two extra weeks provided by the February 15 reporting deadline will help reduce substantially the number of amended tax information returns.

The legislative history of this provision illustrates quite clearly that Congress understood that the February 15 reporting deadline would be available to all such statements irrespective of whether a customer held a security for which gross proceeds reporting would be required were the security to be sold or redeemed. Specifically, the 2007 House-passed bill imposed four very restrictive conditions on a

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<sup>28</sup> Institute President Paul Schott Stevens wrote to the Chairs and Ranking Minority Members of the House and Senate tax writing committees on April 15, 2008, on this issue. The letter stated: “[t]he importance of the February 15 reporting deadline for all tax information provided to fund customers must be emphasized. This modest change is essential to the effective implementation of an administrable cost basis reporting regime.” SIFMA also sent a letter on April 14, 2008, which discussed this issue under the heading “Clarify that the February 15 deadline for filing 1099 statement applies consistently to all information returns mailed by the taxpayer.” SIFMA stated in its letter that, under the industry’s proposal, “the February 15 deadline would apply to any payee statement furnished to the taxpayer . . . [and] is not contingent on reporting characteristics (such as the reporting of gross proceeds) which may change from year to year.”

consolidated reporting statement that would be eligible for the February 15 tax reporting deadline. First, a sale or redemption must have occurred. Second, only those accounts for which section 6045 reporting was required could be included in the statement. Third, the only forms (in addition to those required under section 6045) that could be included on the statement were those required by sections 6042(c), 6049(c)(2)(A), and 6050N(b). Fourth, all of the specifically-permissible information must be furnished as part of the statement.

Because these limitations still presented a number of issues, the Institute and SIFMA discussed with Congressional staff our concerns regarding the House language. As a result, the enacted bill addressed favorably each of these concerns. Specifically, section 6045(b) provides that “[i]n the case of a consolidated reporting statement (as defined in regulations) with respect to *any customer, any statement* which would otherwise be required to be furnished on or before January 31 . . . with respect to *any item* reportable to the taxpayer shall instead be required to be furnished on or before February 15 . . . if furnished *with* such consolidated reporting statement” (emphasis added).

Congress’ intent to apply broadly this February 15 reporting deadline is clear not only from this statutory language but also from the technical explanation of this bill that was prepared by the Joint Committee on Taxation, on September 25, 2008, prior to the bill’s enactment. Specifically, the Technical Explanation states:

The term “consolidated reporting statement” is intended to refer to annual account information statements that brokerage firms customarily provide to their customers and that include tax-related information. It is intended that the February 15 deadline for consolidated reporting statements apply in the same manner to statements furnished for any account or accounts, taxable and retirement, held by a customer with a mutual fund or other broker.<sup>29</sup>

These proposed regulations, while broader than prior guidance on the issue,<sup>30</sup> still do not reflect the full range of information statements intended by Congress to be covered by the February 15 deadline. Specifically, the term “consolidated reporting statement” is defined by the proposed regulations as “a grouping of statements furnished by the same broker to the same customer or same group of customers on the same date *that includes a statement required to be furnished by this section*”

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<sup>29</sup> <http://www.house.gov/jct/x-75-08.pdf> p. 137.

<sup>30</sup> The general instructions to payors for completing 2008 Forms 1099, which were corrected to reflect the new legislation, applied to a narrower subset of information returns. Specifically, the corrected instructions extended the February 15 tax reporting deadline to statements that included only Forms 1099-B, 1099-S, and in certain cases Forms 1099-MISC. In January 2009, following a joint Institute/SIFMA submission on this issue, the IRS issued Notice 2009-11; this Notice stated that the February 15 deadline applied also to dividends and interest (as required under section 6042 and 6049) reported on an annual composite form recipient statement irrespective of whether the investor also sold securities for which a Form 1099-B was required.



(emphasis added). The definition continues, “[f]or purposes of this paragraph (k)(3)(i), a broker may treat . . . a grouping of statements for a customer as including a statement required to be furnished by this section if the customer has an account with the broker for which a statement would be required to be furnished under this section *had a sale occurred during the year*” (emphasis added).

Thus, the proposed regulations would *not* treat as a consolidated reporting statement a statement sent to a customer whose only investments were: (i) money market funds, which are exempt from gross proceeds reporting because the value of the fund shares remains constant, typically \$1 per share; and/or (ii) securities held in tax-deferred retirement accounts such as individual retirement accounts (“IRAs”), which also are exempt from gross proceeds reporting. As explained above, Congress clearly intended these customers also to benefit from the February 15 reporting deadline.

The Institute and SIFMA pushed so aggressively for a fully inclusive February 15 reporting deadline because of the substantial business problems, apparent from the proposed regulations, that will arise if the February 15 reporting deadline is under-inclusive. Specifically, funds today cannot distinguish easily between (1) a customer who has one or more accounts that include securities for which gross proceeds reporting could be required and (2) a customer who does not have any accounts that include such securities. Thus, unless all information returns sent to all customers are treated by final regulations as eligible for the February 15 reporting deadline, funds will be compelled to send all tax information by January 31; in that case, the relief that Congress provided will have little, if any, value. Moreover, the result will be a substantial increase in the number of amended Forms 1099, with unnecessary burdens imposed on funds and brokers, investors, and the IRS, because funds will have insufficient time to collect and report accurate information.

In sum, the final regulations should define a consolidated reporting statement to include all tax information sent by funds and brokers to their customers. Example 3 in Prop. Reg. § 1.6045-1(k)(3)(iii) should be deleted, as its statement that tax information must be sent by January 31 if a customer has only a non-taxable IRA account is inconsistent with Congressional intent. Our recommendation also would address statements sent to taxpayers who have investments held in Health Savings Accounts (which are reportable on Forms 1099-SA and 5498-SA). Many brokers currently include these forms when consolidating mailings to shareholders

The Institute also asks that, for purposes of the February 15 reporting deadline, the proposed regulations refer to a “reporting entity” rather than a “broker.” Notice 2010-9 uses the term “reporting entity,” which is broader than the term used in the proposed regulations. We believe that “reporting entity” encompasses those parties which may be responsible for information reporting but that may not be covered by the definition of “broker” in the regulations under section 6045. For example, it is not clear that a custodian for funds held by an IRA “stands ready to effect sales to be made by others;” thus, under the proposed regulations, a custodian may not be able to take advantage of the extended deadline. The Notice, in comparison, is broad enough to include a custodian. Therefore, we ask that the IRS use the term “reporting entity” for this purpose. Alternatively, the IRS should clarify that use of the term “broker” includes other entities responsible for information reporting to shareholders.

## **V. Transfer Reporting**

The Institute generally agrees with the proposed regulations as they apply to transfers of covered securities and believe these rules are workable, for the most part. We appreciate that the IRS has left many of the decisions regarding form and format to be made by the industry. The Institute's members and service providers have spent a great deal of time over the past few years discussing the new cost basis reporting requirements and how such transfers will occur; there still are a number of open questions that the industry must resolve, and having maximum flexibility will ease this process. We note, however, that there are many different types of transfers that may be covered by the new reporting requirement, and the industry has not yet vetted fully (or even contemplated) all of them. The Institute may have additional comments on transfer reporting as we continue to consider these issues.

We do have a few comments regarding the types of information that must be included on a transfer statement, discussed below. Our primary concerns with the transfer reporting rules, however, are in connection with the transfer of securities held by exempt recipients and gifted and inherited shares. Application of the proposed regulations and existing basis adjustment rules regarding these types of shares will make information reporting very difficult.

### **A. Transfer Statements for Exempt Recipients**

The proposed regulations presume that every security transferred is a covered security, and therefore every transfer must be accompanied by a transfer statement. If the transferred securities are not covered securities, the transfer statement must reflect that, and no other information is required. The preamble to the regulations indicates that this rule requires transfer statements even with respect to transfers of non-covered securities and securities that are held by exempt recipients.

The Institute asks the IRS to amend this rule so that transfer statements are not required for securities held by exempt recipients. Because reporting under section 6045 is not required for these types of securities, requiring transfer statements is superfluous and unnecessarily burdensome. The information currently transferred with such securities indicates that tax reporting is not needed for those shares. For example, if an IRA is transferred from one broker to another, the information passed with the shares will indicate that the account is an IRA, and therefore the receiving broker will know that tax reporting is not required. Similarly, with shares held by a C corporation, the account information will capture the identity of the holder. There is no need for a separate transfer statement indicating that gross proceeds and cost basis reporting is not required. Therefore, the IRS should specify that transfer statements are not required for those securities for which reporting under section 6045 is not required because the beneficial owner is an exempt recipient.<sup>31</sup>

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<sup>31</sup> A majority of fund shares are held in tax-exempt accounts; therefore, tax reporting under section 6045 is more the exception than the rule for funds. Requiring transfer statements for these RIC shares would increase greatly the volume of transfer reporting required by brokers, at a significant cost that would be borne by investors but with no discernable benefit.

## **B. Information Required**

In general, the Institute believes that the information required by the proposed regulations to be included on a transfer statement accompanying the transfer of covered securities is sufficient for both parties to the transaction to properly identify the securities transferred and the adjusted cost basis. We also appreciate that the proposed regulations permit the transferring and receiving brokers to agree to combine the information in any format, including the use of codes to represent certain information. As the vast majority of the transfers will be automated, this flexibility is useful and will reduce the amount of information that actually must be transmitted.

The Institute does have a few comments regarding the information required. First, we do not believe that a transfer statement should include the date of any previous transfer statement with respect to the same transfer. Presumably the purpose of this requirement is to permit the receiving broker to identify the lots to which the transfer statement pertains, so the receiving broker can determine whether the transfer statement is correcting any previous information received with respect to those lots. We do not believe that the date of any previous statement, however, will identify adequately the share lots that are being corrected, and therefore is unnecessary. For automated transfers, the control or account number will identify the lots and whether there have been any previous transfer statements. For manual transfers, the dates of any previous statements will not be useful. The industry is considering this issue and the best means for identifying such information. Therefore, we ask that the proposed regulations simply require the transfer statement to include information that is sufficient to permit the receiving broker to identify the lots to which the transfer statement applies. The industry will determine how such information should be conveyed.

Second, the Institute has concerns regarding the requirement that the transfer statement include the name, address, telephone number, taxpayer identification number, and account number of the beneficial owner or owners both before and after the transfer. Again, for automated transfers such information will be captured by the account number or other code. For manual transfers, however, the industry does not believe that all of this information is necessary and can lead to identify theft concerns.<sup>32</sup> Therefore, we again ask that the proposed regulations simply require that the transfer statement include information sufficient to identify the beneficial owner or owners. The industry is considering this issue as well and will determine what information is necessary to properly identify the beneficial owners; for manual transfers, it may be a combination of information, such as the name and account number. It is not yet clear to the industry, however, how best to convey such information, and we believe the proposed regulations should provide flexibility here.<sup>33</sup>

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<sup>32</sup> The IRS recently announced a pilot program (*see* Notice 2009-93) that would permit financial institutions to mask or truncate the first five digits of taxpayer identification numbers on paper statements sent to taxpayers on Forms 1099 and 5498. If the IRS believes that taxpayer identification numbers are necessary on transfer statements, the proposed regulations should permit brokers to mask or truncate those numbers, consistent with Notice 2009-93.

<sup>33</sup> The receiving broker will have all of this information on the beneficial owner or owners, as it is required when the new account is opened (*e.g.*, the receiving broker already will have a Form W-9 for the beneficial owner). Therefore, the

Third, we note that lot numbers are not relevant for transfers of RIC shares. Lot numbers are assigned by the record keeper, but may not be relevant to other record keepers who receive the shares in a transfer. Therefore, we ask that this piece of information be stricken from the proposed regulations, at least with respect to RIC shares.

Finally, we ask that, should the qualified five-year gain rules not come back into effect in 2011, the IRS amend the rule in the proposed regulations regarding the acquisition dates of shares for which average cost has been used. Specifically, we ask that such shares that have been held for more than one year, rather than shares held for more than five years, may be reported on a single transfer statement with the original acquisition date noted as “various.” There is no need to keep specific acquisition date history for shares held for more than one year if there are only two categories of capital gain (long term and short term). This change would reduce greatly the amount of information that brokers must retain and the number of transfer statements that must be transmitted. Further, it may make more sense to tie this requirement to the categories of capital gain, rather than a specific time period, as this would prevent any changes to the regulations should the holding periods for capital gains change in the future.

### **C. Gifted and Inherited Shares**

The Institute was disconcerted to learn that the IRS believes that gifted and inherited shares are covered securities “within the plain language of the statute,” as stated in the preamble to the proposed regulations. Based on our correspondence with Congressional leaders and our extensive discussions with Congressional staff,<sup>34</sup> we believe that Congress intended to exclude such securities from the cost basis reporting regulations. Our understanding of Congressional intent was not contradicted by the IRS or Treasury Department during numerous discussions of our 2009 comment letter.<sup>35</sup>

Given our understanding of Congressional intent and the difficulties in applying the basis rules for gifted and inherited shares, we ask the IRS to reconsider their stance on these types of transfers. If

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receiving broker does not need to receive all of this information, and only the bare minimum of information needed to adequately identify the beneficial owner or owners should be sent with the transfer statement.

<sup>34</sup> In an memorandum attached to a December 2007 letter from Institute President Paul Schott Stevens to Chairman Baucus and Senator Grassley, the Institute discussed the gifted and inherited shares issue as follows:

H.R. 3996 appears to exclude from the basis reporting requirement shares that are transferred as gifts or inheritances. From a systems and customer relations standpoint, the industry believes it would be better to include those shares in the basis reporting regime with appropriate default rules. For inherited shares, the default rule should be a stepped-up basis (*i.e.*, fair market value at the time of death). For gifted shares and transfers for value, the default rule should be a carry-over basis. In all cases, the fund should be allowed to override the default rule if it receives basis information from the shareholder (with appropriate penalty relief for funds using shareholder-provided information).

<sup>35</sup> We specifically discussed the effect of the new reporting requirements on gifted and inherited shares in our 2009 letter, where we asked for the discretion to apply default rules even though such securities were not covered securities for purposes of the reporting requirements. *See* 2009 Institute letter, p. 20.

the IRS firmly believes that such shares should be covered, then the rules regarding these types of transfers must be revised to provide rules that truly are workable for the industry without being overly burdensome.

Despite the IRS's assertion that the rules provided in the proposed regulations are "workable," these rules present a number of issues for mutual funds. With respect to inherited shares, it is unrealistic to expect a broker to seek information from an "authorized representative of the estate." This places the burden on the broker to actively solicit information when they often may have no idea from whom to seek this information. Additionally, a broker may not become aware that there has been a death until years later. This situation often arises in the case of joint accounts; even though one account owner may die, the broker may not learn of the death until the other joint owner sells or transfers the shares (*if* the other joint owner realizes that the cost basis statement received does not reflect the basis step-up attributable to the first owner's death), or even until the other joint owner also dies. In such cases, requiring a broker to seek out basis information from the authorized estate representative for the first death is impracticable. Even when a broker learns of a death and is able to contact the authorized estate representative, the broker may not receive instructions from the representative until a substantial period of time later. The rule is open-ended, meaning that brokers may have to amend transfer statements years after an original transfer statement was sent; this may mean that subsequent transfer statements or Forms 1099 for the same shares also must be amended.

With respect to gifts, the proposed regulations essentially require brokers to compare the cost basis and fair market value of every lot of securities every time shares are re-registered and thus carry two sets of numbers on their books— both the carry-over basis and the fair market value of the shares on the date of the gift – for every lot on which the cost basis exceeds the fair market value on the re-registration date. Because the basis number used to determine gain or loss upon the sale of gifted shares is not determined until the sale of those shares in this case,<sup>36</sup> brokers may be required to retain this additional information for years. Again, this rule is overly burdensome and contradicts efforts by Congress to minimize the amount of information that brokers must retain for cost basis reporting purposes. Another complication arises if the broker does not know the actual date of the gift. The date on which the shares are transferred to the new account often will not be the actual date of the gift.<sup>37</sup> Therefore, the broker likely will not know which date to use to determine the shares' fair market value. Further, because brokers are not required to adjust basis for gift taxes paid (of which the broker will have no knowledge), the basis information provided by the broker may not match that provided by the shareholder. It is not clear what value is added by having brokers report a number that is not correct.

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<sup>36</sup> See Code section 1015(a). If stock with a cost basis of \$10 is gifted when the stock's value is \$9, the donee's cost basis in the shares is \$10 for purposes of computing gain and \$9 for purposes of computing loss. If the donee later sells the stock for \$9.50, the donee has neither gain nor loss. See Treas. Reg. section 1.1015-1(a)(2).

<sup>37</sup> Treas. Reg. § 1.1015-1(c) provides that the date that the donee acquires an interest in the property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. If a broker receives a letter from a shareholder instructing it to transfer shares to another party, the date of transfer may not be the date of the gift (absent further guidance).

Because we see a number of problems with the proposed regulations on this issue, we recommend simple default rules that easily could be applied. As suggested in our 2009 comment letter,<sup>38</sup> the general rule should provide a default rule that carries over the cost basis of the transferred shares. Thus, as the proposed regulations currently provide, a broker should assume that a transfer from one beneficial owner to another is a gift unless told otherwise. The default rule also should provide that the holding period for gifts is carried over from the holding period of the donor. If the broker knows that the shares have been inherited (*e.g.*, the broker receives a death certificate), the default rule should be a full stepped-up basis on the date of death, in the case of a single account owner, and a proportionate stepped-up basis in the case of joint account owners.<sup>39</sup> The holding period for all inherited shares would be long term. In all cases, the broker should be permitted to override the default rules if the shareholder provides cost basis information. These default rules would report basis correctly for the majority of transfers due to gifts and inheritances. As with wash sales, shareholders still would be obligated to apply the basis rules for gifted and inherited shares, and they could provide such information to their broker.

Without realistic and workable default rules, brokers cannot be expected to apply the basis reporting requirements to gifted and inherited shares. There are too many factual and legal issues outside the broker's knowledge that must be applied, and requiring brokers to find such information and adjust basis accordingly essentially would put them in the role of tax advisors.

Because we did not expect gifted and inherited shares to be treated as covered securities, the mutual fund industry did not spend any time discussing these types of transfers prior to the release of the proposed regulations. The Institute has not had adequate time to fully vet all of the issues that may arise with information reporting on these types of securities,<sup>40</sup> given the short comment period for the proposed regulations. Therefore, we will continue to consider these issues and provide additional comments over the next few weeks.

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

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<sup>38</sup> See 2009 Institute letter, p. 21.

<sup>39</sup> For example, if a joint account has two owners, and one of the owners dies, the broker would step up to fair market value on the date of death the basis of 50% of the shares in the joint account.

<sup>40</sup> One such issue involves the situation in which an account owner transfers one half of the shares to each of two donees. Default rules will be needed for determining how to allocate the cost basis between the new accounts. A mutual-fund-specific default rule might provide that each lot is split equally between the new accounts. Such a default rule might not be administrable, however, for securities that cannot be traded in fractional shares.

## VI. Corporate Action Reporting

The Institute understands the need for reporting on corporate actions that can affect basis. With respect to RIC shares, however, this information currently is being provided on a timely basis, and we believe the procedures set forth in the proposed regulations are unnecessary. If a mutual fund merges with another fund, distributes a return of capital, or engages in some other type of corporate action, the fund itself will adjust the basis of those shareholders holding shares directly on the fund's books and will report such information to those shareholders under the cost basis reporting requirements of section 6045(g).

For those mutual fund shares held through a broker/dealer, the mutual fund and brokerage industries have developed a process for transmitting such information, and we believe this process adequately notifies the relevant parties of any effect a mutual fund corporate action may have on RIC shares. For well over twenty years, the Institute has worked with SIFMA (and SIFMA's predecessor, the Securities Industry Association) each year to produce a year-end tax reporting spreadsheet that is utilized by the mutual fund industry.<sup>41</sup> This spreadsheet is designed to capture information such as the amount of any distributions, the character of such distributions and whether such distribution has been reclassified (*i.e.*, whether there has been a return of capital), and whether there has been a merger or other change resulting in a new CUSIP number for a fund. The spreadsheet is amended each year to include any new information that brokers will need for tax reporting purposes; information regarding basis and adjustments to basis will be included in future spreadsheets. Each year mutual funds complete this spreadsheet and distribute it to any broker or tax reporting agent that holds shares in those funds on behalf of clients. This information generally is provided to the brokers in early to mid-January each year, on a date discussed between SIFMA and the Institute.

We believe this process works well and need not be supplemented by a corporate action reporting requirement. Therefore, we ask that the IRS set forth a safe harbor, whereby RICs that provide information to brokers through the year-end tax reporting spreadsheet process are deemed to have complied with the corporate action reporting requirements in the proposed regulations.

If mutual funds are required to comply with these requirements as issuers of securities, we ask the IRS not to require RICs to issue identifying numbers with respect to returns of capital. We feel this requirement is unnecessary and overly burdensome, and the use of such identifying numbers will not provide any benefit to brokers who receive such information.

As the holder of corporate securities in their portfolios, the mutual fund industry is concerned about the ability of issuers to post the required information on their websites rather than sending such information to shareholders. It is not clear how often shareholders are expected to check the websites of the issuers for information affecting basis. For many funds, this could mean periodic checks of thousands of websites. Such a requirement is overly burdensome and places the onus on the holder of

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<sup>41</sup> We gladly will provide a copy of this spreadsheet to the IRS if wanted.

the stock to seek out such information. We understand that SIFMA is recommending that issuers furnish such information to each clearing organization (as defined in the regulations under section 163);<sup>42</sup> given the issues raised by the proposed regulations, we support this recommendation.

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

Finally, the proposed regulations should provide that a broker has received “notification” of an issuer action affecting basis when the broker is notified that such information is on the issuer’s website, if the issuer posts the information on the web rather than sending information statements. This is important to the extent that a broker must correct a transfer statement or Form 1099-B because of an issuer statement affecting the basis reported. A broker should not be penalized for failure to make the correction until the broker actually has notice of the adjustment.

## **VII. Penalty Provisions**

As discussed above and in our 2009 letter, mandatory cost basis reporting will impose significant burdens on the mutual fund industry. Extensive changes must be made to current systems, while others must be built from scratch. Although the industry already has spent a significant amount of time discussing how to comply with the new requirements, the majority of the necessary work cannot begin until final regulations are released. Once the industry knows exactly what it must do, it must then build the systems, followed by extensive testing to ensure that everything works properly. It is inevitable that problems will arise and kinks will need to be worked out once the systems are on line. Aside from the primary programming burdens, many ancillary systems will need to be modified. Also, brokers must communicate with their shareholders regarding default methods and basis selections, and they must train and educate their employees. Therefore, even if final regulations are issued early in 2010, it is not clear that brokers will be able to comply fully with the new reporting requirements by 2012.

The problems of preparing to capture and report cost basis are compounded by the fact that a number of tax provisions, including provisions affecting categories of capital gains, are set to expire after 2010. Most notably, the qualified five-year gain rules (for securities held for more than five years) will come back into the tax code in 2011, unless Congress acts. Whether or not brokers must account for this type of gain will have a significant impact on the building and programming of cost basis reporting systems. Although members of Congress and the administration have suggested that the current capital

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<sup>42</sup> A similar process already is in place for corporate inversions that are reported on Form 1099-CAP.



gains regime will be extended or made permanent, nothing yet has been done. Again, brokers cannot begin making the necessary programming changes until the rules in 2011 and thereafter are certain.

Therefore, the Institute asks the IRS and Treasury Department to provide transition relief to the industry. This transition relief should provide that the government will not impose penalties for a failure to properly report basis information to shareholders or the IRS, to the extent the broker has used best efforts to comply. We believe this transition relief should apply at least for the first three years following the effective date for RIC shares.

If the IRS does not provide general transition relief, we ask that the government provide limited transition relief for gifted and inherited shares, if the IRS does not change its stance that these shares are covered securities. As discussed above, the industry did not contemplate that these shares would be covered securities, and complying with these rules will require additional thought, time and programming, above that which is needed for the more basic reporting requirements. Planning for these rules is complicated by the fact that Congress has not yet addressed the estate tax issue, and it is not clear what the rules will be after 2010. Therefore, we strongly believe that additional time is needed to properly comply with these requirements.

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The Institute appreciates the opportunity to comment on this important regulation project. We look forward to discussing these issues further at the public hearing on February 17. In the meantime, should you have any questions, please contact me at (202) 371-5432 or [kgibian@ici.org](mailto:kgibian@ici.org).

Sincerely,

*/s/ Karen L. Gibian*

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