

Investment Company Institute Webinar

Implementing Cost Basis Reporting for Mutual Funds

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Speakers

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Cost Basis Reporting Topics

- Proposed cost basis reporting requirements and outstanding issues
- Implementing cost basis reporting using average cost for bifurcated accounts and single account elections
- Automating proposed transfer reporting requirements between brokers and other considerations
- Shareholder servicing and communication challenges and issues

Cost Basis Reporting Terminology

- **Broker**: For cost basis reporting purposes, anyone with tax reporting responsibility. Here, “broker” includes both mutual funds and broker/dealers.
- **Transfer**: In-Kind transfer between two reporting brokers. Includes both like-registration changes (transfer from broker to broker without change in beneficial ownership) and re-registrations (change in beneficial ownership due to death, gift) where cost basis must also move.
- **Lot Depletion**: Order in which tax lots are drawn down on an account. Methods are typically age-based or cost-based.

Cost Basis Reporting Terminology

- **Default Method**: Broker-selected basis calculation method, absent shareholder instruction. Also used to determine broker's lot depletion, absent shareholder instruction, to determine gain or loss on an account's debit activity.
- **Bifurcated Account**: For accounts in which average cost is used, covered shares are tracked separately from non-covered shares and are treated (deemed) as two separate accounts.

Cost Basis Reporting Terminology

- **Covered Shares**: Shares for which mandatory cost basis reporting is required. Includes:
 - Mutual fund shares acquired on or after Jan. 1, 2012, and
 - Shares transferred from an account in which such shares were covered securities, provided they are accompanied by a transfer statement that includes the shares' basis information.
- **Non-Covered Shares**: Shares for which mandatory cost basis reporting is not required because:
 - Acquisition prior to January 1, 2012; or
 - No basis information is received in a transfer from an account in which such shares were covered securities.

Cost Basis Reporting Terminology

- **Single Account Average Cost**: Broker election whereby shares acquired *prior* to January 1, 2012, are combined with shares acquired on or after January 1, 2012, to provide a single average cost for the account. Pre-January 1, 2012 shares become “covered shares” for basis reporting.
- **Revocation**: The ability of a shareholder to switch from average cost to another method within the earlier of 1 year of an average cost election or prior to/concurrent with first redemption. Broker may extend 1 year period but not beyond first redemption.

Cost Basis Reporting Overview

Karen Gibian
Investment Company Institute

Cost Basis Reporting: Where Are We Today?

- Effective for fund shares acquired after December 31, 2011
 - Effective for other equities acquired after December 31, 2010
- Proposed regulations issued December 2009
- Final regulations expected summer/fall 2010
- 18 Months to implement – numerous issues to resolve

Outstanding Issues: Average Cost

- Proposed regulations require shareholders to elect average cost method *in writing*
 - Writing requirement should be eliminated
 - Industry prefers maximum flexibility in communicating with clients
 - Written election is impracticable
 - Unclear how writing requirement interacts with broker default method
- Proposed regulations require shareholders to seek IRS consent before switching from average cost to another method
 - Shareholders should be permitted to switch easily from average cost to another method
 - Requiring IRS consent will be confusing and time-consuming
 - Broad general consent could be granted

Outstanding Issues: Single-Account Election

- Election made by the broker but unclear how shareholder actions affect the election
 - Shareholder revokes or changes average cost method or transfers to a new account
 - Pre-effective date shares should remain “covered”
- Accuracy requirement for pre-effective date shares: “broker neither knows nor has reason to know such information is inaccurate”
 - Unclear what this standard means
- Unclear whether brokers may take shareholder-provided information for purposes of the election
 - Application of accuracy requirement seems to preclude this

Outstanding Issues: Transfers

- Proposed regulations require transfer statements for accounts exempt from reporting (IRAs, money market funds)
 - Transfer statements are not necessary for these accounts
 - Asset transfer information indicates account type including those not subject to reporting
- Proposed regulations require certain information on transfer statements that is not necessary
 - Brokers should have maximum flexibility with respect to form and format of transfer statements
 - Industry will determine best means of conveying the necessary information

Outstanding Issues: Gifted and Inherited Securities

- Proposed regulations treat gifted and inherited shares as “covered” securities
- “Applicable Persons” must send transfer statements for gifted and inherited shares
 - Inherited Shares – Must seek basis information from “authorized estate representative”
 - Gifted Shares
 - Must report donor’s basis and FMV of shares on date of gift
 - Receiving broker must maintain both numbers, as donee’s basis may depend on FMV of shares upon subsequent sale
- Proposed rules raise significant implementation issues

Gifted and Inherited Shares (Cont'd)

- Industry's proposed default rules
 - Inherited Shares – Adjust basis to FMV on date of death; long-term holding period
 - Gifted Shares – Carry over donor's basis and holding period
 - In all cases, brokers may take shareholder-provided information if default rules are incorrect

Other Outstanding Issues

- Adjustments to amount of gain/loss reported on Form 1099-B
 - Wash sales
 - Six-month conversion rules
- Corrected Forms 1099-B
 - *De minimis* rule
 - Three-year limit
- Corporate action reporting – applicability to fund industry
 - Use of ICI year-end tax spreadsheet process
- Transition relief
 - No penalties for some period after implementation if best efforts to comply

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**Please answer the polling
question.**

Thank you

Cost Basis Reporting: Average Cost

Nino Palermo
American Funds

Cost Basis Reporting:

Average Cost Method

- **Average cost accounting method created specifically for RICs**
 - Shareowners tend to purchase over time and reinvest dividends/capital gains
 - Shareowners are not precluded from using other methods
 - Election is irrevocable for life of account
- **Mutual fund industry voluntarily began providing basis information to shareowners in the early-90's**
 - Most funds provide only average cost
 - Information is provided as a service and is not reported to the IRS
 - Information is not provided to all eligible shareowners (e.g., transfers, gifted/inherited)
 - Funds have no way of knowing how many shareowners use the information

Cost Basis Reporting: *Average Cost Method*

- **Single Account v. Bifurcated (Pros)**
 - Least amount of disruption to existing shareowners
 - Simplest to communicate to shareowners
 - Only 1 average cost number is calculated
- **Single Account v. Bifurcated (Cons)**
 - All shares become covered
 - Shareowner provided data
 - Election is irrevocable for life of account
 - Average cost not available for all shareowners
 - Shareowners that do not use average cost

Cost Basis Reporting: *Average Cost Method*

- **Average Cost as a Default Method**
 - Consent from shareowner in writing
 - Irrevocable without IRS consent
 - Shareowner communications
 - Selective default considerations
 - Lot management
 - Changes of reporting method

- **Choosing another Default Method**
 - Shareowner communications
 - TA representative training
 - Lot management
 - Standing orders

Cost Basis Transfer Reporting for Mutual Funds

Jeff Naylor
SunGard

Operational Considerations

- **Lot Depletion**

- Recommended Practice: Remove non-covered Shares FIRST – regardless of method and regardless of Acquisition Date assigned to tax lot
- Why?
 - Gets account to matching – the IRS goal
 - Gives shareholders the most flexibility in reporting Basis during transition periods
 - Makes consistent across methods – easier for training, easier for shareholder education
 - Removes non-covered Average Cost shares in a bifurcated Average Cost account first
- Challenges?
 - Systems may want to apply age-based methods (FIFO, LIFO) in Acquisition Date order
 - Acquisition Date may be irrelevant on non-covered share lots where basis is unknown; thus depletion method is based on potentially inaccurate data

Operational Considerations

- Partial Transfers
 - Required: In-Kind partial transfers between reporting Brokers must be moved on a FIRST-IN / FIRST-OUT (FIFO) basis absent shareholder instruction.
 - Outstanding Issue: How to handle partial transfers requiring re-registration of shares (like gifts, inheritance or divorce).
 - Proportionately
 - Per legal documents
 - Per shareholder instructions
 - Why?
 - Proportional lot movement permits equitable sharing of cost basis between parties

Operational Considerations

- Broker to Broker Transfers
 - Recommended Practice: Leverage DTCC CBRS Solution
 - Asset Record and Tax Lot Record
 - Will tie to various DTCC Services, including ACATS Fund/SERV and Networking
 - Can also be used to move lots independent of those products
 - Phase 1 development for Equities is underway; Phase 2 in 2011 for Mutual Funds
 - Manual Transfers are most likely an unfortunate reality
 - Need all parties to participate in an automated solution
 - Otherwise - manual tracking and data entry requirements
 - Corrected Lot Transfers are also an unfortunate reality when...
 - A Corporate Action – like Return of Capital – is determined, and you were the holder of those shares on the ROC effective date
 - Corrective transaction processing is needed which impacts Cost Basis
 - Basis is received within 15 days of transfer of non-covered shares

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question.**

Thank you

Shareholder Servicing and Communications Challenges and Issues

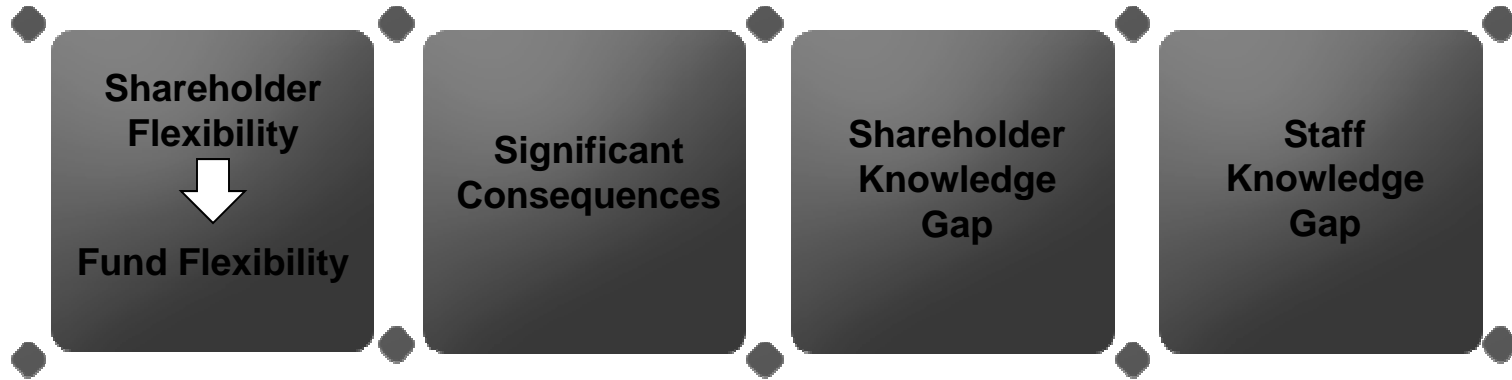
Charles Hawkins
PNC Global Investment Servicing

Cost Basis Reporting

**Shareholder
Communications
Challenges**

**Things to
Think About**

Shareholder Communications Challenges



Shareholder Communications Challenges

- Shareholder Flexibility → Fund Flexibility
- Shareholder Knowledge Gap
- Staff Knowledge Gap
- Significant Consequences

Potential Solutions

- Define what shareholder standing instructions will be supported
 - Average Cost
 - FIFO
 - Specific identification – but how many flavors?
- Define what shareholders must do to:
 - Communicate standing instructions
 - Communicate trade specific instructions
 - Specific ID may not always be feasible!

Shareholder Communications Challenges

- ◇ Shareholder Flexibility → Fund Flexibility ● Significant Consequences
- ◇ Shareholder Knowledge Gap ◇ Staff Knowledge Gap

Potential Solutions

- Carefully consider irrevocable decisions
 - Average Cost election (as fund default)
 - Single Account election
- Clearly communicate
 - Plain language – consider audience
 - Consider format
 - Opt out – how/when

Shareholder Communications Challenges

- ◊ Shareholder Flexibility → Fund Flexibility
- ◊ Significant Consequences
- Shareholder Knowledge Gap
- ◊ Staff Knowledge Gap

Potential Solutions

- Benefit of 1/1/2012 effective date
- Clear communication
 - Written communication
 - Websites
 - Resources for questions

Shareholder Communications Challenges

- Shareholder Flexibility → Fund Flexibility ○ Significant Consequences
- Shareholder Knowledge Gap ○ Staff Knowledge Gap

Potential Solutions (cont)

- User-friendly forms
 - Existing shareholder solicitations
 - S corporations
 - Existing account election forms
 - New account applications
- Timing

Shareholder Communications Challenges

- ◇ Shareholder Flexibility → Fund Flexibility ◇ Significant Consequences
◇ Shareholder Knowledge Gap ◆ Staff Knowledge Gap

Potential Solutions

- Training
- Call center scripting
- Tools/job aids
- Create subject matter expertise resource center
- Post implementation fine tuning

Things to Think About



Things to Think About

◆ Before Trading ○ During Trading ○ After Trading

- Identify S corporations
- Communicating defaults
- Communicating shareholder options
 - Existing accounts
 - New accounts
- Shareholder education/resources
- Call center planning
 - Staffing impact
 - Training

Things to Think About

◊ Before Trading ● During Trading ◊ After Trading

- Call center

- Staffing (call volumes and average talk times)
- Feedback → information delivery & processing improvements
- Trade acceptance and inquiry scripts
- VRU systems

- Website

- Hypotheticals – externally facing resource?
- Trading interfaces
- Shareholder FAQ

Things to Think About

○ Before Trading ● During Trading ○ After Trading

- Hard copy trade processing defaults
 - Enhancements to up front trade review
 - QC/QA
- Contacting executors
 - How to identify
 - Establishing credentials

Things to Think About

○ Before Trading ○ During Trading ● After Trading

- Issue resolution
- Correction acceptance policies

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Questions ???

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