

INVESTMENT COMPANY INSTITUTE  
SUBMISSION TO THE  
SENATE FINANCE COMMITTEE STAFF  
ON COST BASIS REPORTING  
June 28, 2007

The Investment Company Institute<sup>1</sup> appreciates this opportunity to comment on the Senate Finance Committee staff's draft cost basis reporting proposal. We commend the staff for seeking to assist taxpayers in complying with their tax obligations. For this very reason, over the past 15 years, a substantial portion of the mutual fund industry has voluntarily provided basis information to a significant, and growing, portion of its shareholders.

The Institute has participated actively in cost basis reporting discussions since this legislative initiative first was raised in 1990. Since January 2006, we have spent considerable time with industry tax and operations experts examining the remaining operational impediments to mandatory cost basis reporting on all fund share purchases. Our views have evolved as our members have focused more intently on some of the thorniest operations issues. The recommendations in this submission reflect considerable effort by a wide range of industry experts.<sup>2</sup> Before describing these recommendations, three initial points must be emphasized.

First, a mandatory basis-reporting regime will be costly, and the cost ultimately will be borne by fund investors. Therefore, it is imperative that mandatory basis reporting be administrable and effective for shareholders, funds, brokers and other distributors, and the government. The basis adjustments required by the Internal Revenue Code (the "Code") can be complex and may require information not known to funds. Funds and brokers will need clear guidance, including final Treasury regulations, on how to make these adjustments and on their obligations for sending and amending cost basis information provided to shareholders.

Second, sufficient time must be provided to ensure that necessary programming and systems challenges are addressed effectively. Cost basis information provided voluntarily today may not take into account all basis adjustments. The systems required to transfer cost basis information between funds and brokers do not exist today, and existing systems to transfer cost basis information between

<sup>1</sup> The Institute's members include 8,781 open-end investment companies (mutual funds), 665 closed-end investment companies, 428 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.917 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

<sup>2</sup> The Institute's comments and recommendations focus on mutual funds and their

shareholders, but they would not preclude brokers from benefiting from our suggested statutory changes and Committee Report recommendations.

Moreover, we anticipate that our comments and those of other members of the securities industry will overlap in many important respects.

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different brokers are not used by all brokers. Requiring funds to report and transfer information before systems are ready would undermine severely the effectiveness of a reporting regime.

Finally, the flexibility the current law provides to mutual funds and their shareholders to compute cost basis under any available method (first-in, first-out ("FIFO"), specific identification, and average cost, in the case of fund shareholders) must be maintained. Any limitation on available methods would be a tax increase on savings. Further, it would create shareholder confusion if they were required to begin using a method different from the method they have used previously.

We recognize that allowing this flexibility will limit the use of cost basis information for Internal Revenue Service ("IRS") matching purposes. Our strongly held view is that this flexibility is essential; the IRS will benefit considerably from the enhanced compliance that will follow merely from shareholders' receipt of cost basis information. Compliance would be enhanced further if the IRS were to amend IRS Form 1040 Schedule D so that taxpayers using a cost basis other than the one reported could note this difference on the Form.

The recommendations we make in this submission can be administered by funds, we believe, so long as sufficient lead time is provided to develop the necessary reporting infrastructure. If implemented by the Congress, our recommendations will provide shareholders and the IRS with reliable and useful information. We look forward to continuing our discussions with the Committee staff and working with all relevant parties as this legislation moves forward.

## I. Background

### A. Current Practices

#### 1. In General

Mutual fund shareholders may calculate cost basis using FIFO, specific identification, or the average cost method.<sup>3</sup> Once a shareholder elects to compute basis under the average cost method, this method must be utilized for all shares in the shareholder's account.

A large number of mutual funds currently provide average cost basis information to a substantial portion of their shareholders. Some funds (particularly smaller fund companies) do not provide cost basis information today, and no fund provides this information to all its taxable investors.

Cost basis information is not provided to an individual investor if the fund does not have, or cannot access, the necessary information or is not confident that the information it has is accurate.

This information may not be provided today on accounts opened before cost basis was provided

voluntarily, accounts that include "internally transferred" shares (typically arising from an account reregistration at the fund's transfer agent), and accounts that include "externally transferred" shares (typically arising from a transfer of the customer account between the broker and fund). In the case of

3 Treas. Reg, section 1.1012-1(c). Direct holders of equities may use only FIFO or specific identification.

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internal or external transfers, as discussed below, the fund typically will not know the correct cost basis

of the transferred shares. Under all of these circumstances, the shareholder must calculate and report

cost basis with limited (e.g., historical) or no information provided by the fund.

Funds' current voluntary cost basis reporting systems, while quite advanced, may not take into

account all potential basis adjustments. These adjustments may not be made because they have limited

applicability or are difficult for the fund to track. Alternatively, funds may not make adjustments that

are triggered by post-year-end transactions, which may affect retroactively the cost basis of redemptions

that occurred in a prior calendar year and thus could require funds to amend cost basis statements that

already have been sent to shareholders.

## 2. Relevant Systems

Many systems and processes are necessary to support voluntary reporting of average cost basis

data to shareholders. The fund transfer agency system maintains shareholder trade data used for

investor statements and basis reporting. Most mutual fund companies contract with software vendors

for their transfer agency systems, although several major mutual fund companies have developed

proprietary transfer agency systems. In both the vendor-supplied and proprietary models, cost basis

reporting may be completed on the transfer agency system directly, or on a system ancillary to the

transfer agency platform. Whenever multiple systems are involved, the coordination needed between

the systems adds to the complexity of calculating and reporting cost basis to shareholders.

The Depository Trust Clearing Corporation ("DTCC") developed and maintains a system for

transferring customer data between its participating firms (generally brokers and banks). This system,

the Automated Customer Account Transfer Service ("ACATS"), was modified about two years ago to

include the Cost Basis Reporting Service ("CBRS"). CBRS is available only if both

brokers are DTCC participants that participate voluntarily in ACATS, elect to participate in CBRS, and maintain (or plan to maintain) cost basis records for the shareholder. Funds currently do not use ACATS and CBRS, and DTCC may need to implement enhancements in order for basis information to be transferred between funds and brokers. 5

4 The thirty firms that participate currently in CBRS process a majority of, but substantially less than all, ACATS transfers. DTCC estimates that roughly 35% to 40% of the assets transferred through ACATS are followed by a later transfer of tax lot records through CBRS.

5 ACATS is not a universally-available solution. Many smaller brokers and other financial intermediaries are not DTCC participants (and hence cannot use ACATS or CBRS). Moreover, many DTCC participants do not use ACATS for all of their account transfers. Finally, mutual funds are not ACATS participants (although fund shares held by brokers for their clients may be transferred on ACATS).

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3. Data Storage and Functionality  
Industry practices for maintaining cost basis information vary. Some funds may have access to historical data for twenty years or more. Others may retain data for only a few years, even though the shareholder may have owned the shares longer. These differences result from many factors, including transfers of accounts from one intermediary to another, changes of ownership in accounts, changes in system vendors (or from proprietary to vendor-supplied), and consolidations or acquisitions of mutual funds.6

Because many different vendor and proprietary solutions are utilized today, there is no uniform cost basis functionality. The following characteristics, however, are common across mutual fund companies currently providing average cost basis information to shareholders:

- The calculation method used is single-category average cost.7
- The calculation process utilizes a mix of data currently available online and an average cost value aggregated from archived data, the availability of which varies across fund companies.
- The holding period is reported as either short-term or long-term (as defined in the Code), not date specific.
- Information is supplied to shareholders through various means, including separate year-end tax statements.

#### B. Application of Staff Draft to Average Cost Method

Although the staff's draft intends to apply the new basis reporting regime prospectively only, average cost basis reporting for shares acquired after the effective date and held in an account opened before the effective date appears to require pre-effective date basis information to

be taken into account.

Unlike specific identification or FIFO, average cost is calculated using the basis of all shares in an account. Thus, absent special rules, applying average cost to post-effective date shares requires funds to pull into the calculation the basis of pre-effective date shares. The basis on pre-effective date shares, if provided by the fund, may not be accurate for a variety of reasons, or it may not be available at all. This retroactive aspect of cost basis reporting is unique to mutual funds. Consequently, special considerations must be given to existing accounts, regardless of whether or not the funds currently are reporting basis information.

6 Cost basis information may not be carried over when two funds merge if the funds use different transfer agency systems.

7 The Treasury regulations provide two methods for determining average cost: double-category and single-category. Treas. Reg. §§ 1.1012-1(e)(3), (4). Under the double-category method, shares in an account are divided into a short-term (held for one year or less) or a long-term (held for more than one year) category. Average cost then is calculated separately for each category. Treas. Reg. §1.1012-1(e)(3). Under the single-category method, the cost basis of all shares in an account is used to determine average cost, regardless of holding period. Treas. Reg. § 1.1012-1(e)(4).

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## II. Effective Date and Application to Existing Accounts

### A. Effective Date

Although many funds today voluntarily provide cost basis information to a substantial portion of their shareholders as a customer service, the programs for calculating cost basis may include administrative simplifications that would not satisfy a legislative mandate. In those cases in which no systems exist currently, they must be built. Funds therefore need sufficient lead time to build and program their systems to provide cost basis information to all of their shareholders in all circumstances. Given the complexity of the basis rules and the magnitude of the data that must be stored, transferred, and reported, these changes cannot be made quickly. We recommend a sufficiently delayed effective date.

The transition to a cost basis reporting regime will be more administrable, we submit, if the new regime becomes effective on January 1 of a specified year and is applied on a calendar-year basis. It would create unnecessary confusion for shareholders and unnecessary administrative burdens for funds if basis reporting became effective mid-year. A "mid-year" approach would require funds to track and report cost basis for some, but not all, shares purchased during that year.

Finally, and importantly, funds must know their cost basis calculation and reporting obligations before they can finalize necessary systems changes. Funds will not be able to

address specific systems issues until they know exactly what will be required. Because the staff's draft leaves many of the new regime's details to the Treasury Department and the IRS, funds will not know the precise reporting and transfer requirements until the Treasury Department issues final regulations. We recommend, therefore, that the effective date for cost basis reporting be tied to the promulgation of final regulations. Otherwise, systems development efforts made before such time may have to be redone after final rules are issued.

Specific Statutory Recommendation. The Institute recommends that the draft proposal be modified to apply to returns the due date for which is the later of:

1. December 31 of the calendar year that ends more than 18 months after the date of enactment, or
2. December 31 of the first calendar year that ends at least twelve months after the

issuance of final regulations by the Secretary. This requirement would apply with respect to securities acquired in or after the calendar year ending on the later of such dates.

#### B. Application of Effective Date to Accounts for which Cost Basis is Reported Currently

Consideration must be given to how a prospective effective date will be applied to those funds that currently provide average cost basis information to some of their shareholders. As noted above, the

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draft's prospective effective date apparently requires that the cost basis of existing shares in an account be included in computing the cost basis of post-effective date shares if the fund reports basis under the average cost method. To the extent that funds wish to continue providing basis information on pre-effective date shares as a service to their customers, guidance is necessary regarding how funds will report this pre-effective date basis and the extent to which information reporting penalties will apply.

#### Situation 1-- Cost Basis NOT Reported to the IRS for Pre-Existing Shares

We anticipate that many funds will prefer to continue reporting average cost basis information voluntarily to shareholders, but not to the IRS, on pre-effective date shares. Some of these funds may prefer to continue to provide this information to shareholders as supplemental tax information; others may prefer to report it (to shareholders only) on the official IRS Form 1099, with a notation that this information is for pre-existing shares and is not being reported to the IRS.

These funds will calculate average cost basis by taking into account the basis of both pre-effective date and post-effective date shares. Once the pre-effective date shares

are redeemed, all future redemptions will be reported to the IRS using average cost.

Because the cost basis of post-effective date shares will be determined, in part, by reference to the cost basis of the pre-effective date shares, guidance is needed regarding a fund's ability to rely on the average cost basis already calculated for the pre-effective date shares. This guidance is necessary because the cost basis on the pre-existing shares may have been calculated (1) entirely by the fund (based upon internally-generated information), (2) in whole or in part based upon information supplied by the shareholder, and/or (3) in whole or in part based upon information transferred from a broker.

Specific Committee Report Recommendation. The Institute recommends first that the Committee Report confirm that voluntary reporting on pre-effective date shares is not subject to information reporting penalties, even if the cost basis is reported (to shareholders only) on the "official" IRS Form 1099. Second, we recommend that the Committee Report clarify that any errors resulting from the inclusion of the cost basis of pre-effective date shares in determining the average basis of post-effective date shares will be deemed to be attributable to reasonable cause and that the reasonable cause penalty standard does not require funds, with respect to the cost basis of post-effective date shares, to re-examine the cost basis of the pre-effective date shares.

Situation 2-- Election to Report Cost Basis for Pre-Existing Shares to the IRS on "Official" Forms

We anticipate that some funds will prefer to provide average cost basis information voluntarily on Form 1099 to both shareholders and the IRS for pre-existing shares. These funds, we understand, believe their shareholders will prefer to receive all cost basis information for both pre-existing and post-effective shares and accounts in a consistent (Form 1099) format.

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Funds would calculate average cost basis by taking into account the basis of both pre-effective date and post-effective date shares. Funds would indicate on a revised Form 1099-B that the basis reported includes basis calculated on pre-effective date shares.

Specific Committee Report Recommendation. The Institute recommends first that the Committee Report confirm that voluntary reporting on pre-effective date shares is not subject to information reporting penalties, even if (in contrast to Situation 1, above) the cost basis is reported to both shareholders and the IRS on the "official" IRS Form 1099. Second, we recommend that the Committee Report clarify (as in Situation 1, above) that any errors resulting from the inclusion of the cost basis of pre-effective date shares in determining the average basis of

post-effective date shares will be deemed attributable to reasonable cause, and that the reasonable cause penalty standard does not require funds, with respect to the cost basis of post-effective date shares, to re-examine the cost basis of the pre-effective date shares.

C. Application of Effective Date to Accounts for which Cost Basis is not Reported or

Available Currently

Different considerations will apply to those accounts for which cost basis is not reported or available currently. As discussed above, these situations include accounts opened before cost basis was provided voluntarily and accounts that include "internally transferred" or "externally transferred" shares.

The industry's primary concern with accounts on which cost basis information has not yet been provided is that existing Treasury regulations require that average cost basis be calculated based upon the cost of all shares in the account. Without creating a new account, which would involve considerable shareholder confusion and additional cost, it is not clear how a fund should calculate an average cost for post-effective date shares in the account without knowing the cost basis of the preexisting shares. As discussed below, funds are considering two different approaches for addressing this issue.

Situation 1 - FIFO Presumption

We anticipate that most funds will prefer to apply a "FIFO presumption" to accounts for which cost basis information is not being provided currently. Specifically, these funds will presume that shareholders will redeem shares from an account on a FIFO basis until all of the pre-effective date shares have been redeemed. At that point, the funds will be able to compute an average cost for all shares remaining in the account, all of which were purchased after the effective date. Thereafter, the funds could report average cost basis in compliance with the cost basis reporting legislation.

One issue with this approach could arise if a shareholder instructs the fund to redeem post-effective date shares while pre-effective date shares remain in the fund. <sup>8</sup> This might occur if the shareholder were using the specific identification method for calculating cost basis. In this case, the

<sup>8</sup> We note that that the occurrence of this scenario likely will be limited.

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shareholder would not be using the average cost information provided by the fund, but the fund still would have the obligation to report basis information to the shareholder and the IRS. The current-law

formula for calculating average cost would require the fund to include in its calculation the basis of the old shares, on which basis information is not available.

Specific Committee Report Recommendation. The Institute recommends that the Committee Report instruct the Treasury Department to amend the cost basis reporting regulations to clarify that a fund may exclude the pre-effective date shares when calculating basis on the post-effective date shares. In addition, as noted above for situations in which cost basis reporting has been provided on existing accounts, the Committee Report should clarify that funds would have no reporting obligation with respect to pre-effective date shares.

#### Situation 2 - Option to Reconstruct Basis

We anticipate that a small number of funds may prefer, on an account-by-account basis, to reconstruct retroactively the cost basis on shares for which cost basis reporting currently is not being provided. This reconstructed basis would be used to report average cost with respect to both old and new shares. Reconstruction could be based upon efforts or determinations made independently by the fund and/or with shareholder input. Though many funds report that they cannot efficiently reconstruct basis retroactively, this option should remain available for those funds that can and wish to use it.

Specific Committee Report Recommendation. The Institute recommends that the Committee Report provide that a fund using good faith efforts to reconstruct basis would have reasonable cause for any errors in the reconstruction. In addition, the Report should provide that funds have reasonable cause to report cost basis by reference to information provided by shareholders. The funds would have an obligation, however, to determine if the information provided was facially unreasonable. In this case, the fund could report and rely upon the basis information provided, so long as the fund's determination of "unreasonableness" was reported to the shareholder and the IRS.

#### III. Scope

##### A. Internal Transfers

Several factors can impact the maintenance and calculation of cost basis when an account is reregistered within an individual mutual fund (i.e., when the name and tax identification number on the account are changed). In general, the fund industry does not transfer the cost basis from the original account to the new re-registered account because the fund has no independent knowledge of the cost basis of the new shares. As discussed below, the correct cost basis for the re-registered shares could be a carryover basis, a partial or full fair market value stepped-up basis, or a basis calculated by reference to other factors (e.g., a "transfer for value").

Share re-registrations may occur when shares are: (1) transferred to or from accounts with multiple owners; (2) inherited from another person; (3) gifted from another person; or (4) transferred for value. Share re-registrations present knowledge issues (e.g., the reason that the shares are transferred) and property right issues (e.g., the transferor's and transferee's rights, under state law, in the shares, which can affect the basis adjustments). In many cases, the fund will not know either the reason for the transfer or the relevant state law considerations.

Issues involving transfers are be particularly difficult when shares are transferred to or from accounts with multiple owners. The relevant cost basis can turn on factors such as whether one or more joint account owners purchased shares in the account and the relevant contributions to the account by the joint owners.

When shares previously held by a single owner are inherited, re-registration typically is effected upon receipt of a death certificate. The fund, in this situation, will know both that the shares are inherited and the date of death. In most cases, under the tax law, the shares will receive a stepped-up basis equal to the share value on the date of death, although an alternative valuation date may be applicable. If the shares are held in a joint account and one of the account owners dies, the fund may not have knowledge of the death, particularly if one of the joint owners is entitled to effect share transactions without consent of the other. In this case, the fund could be calculating an incorrect basis for many years. Moreover, state laws may cause the basis step-up to turn on factors beyond the fund's knowledge.

The general rule for gifted shares is a carry-over basis. The computation is somewhat more complicated, from a knowledge perspective, if gift tax is paid on the transfer, in which case the gift tax is included in the cost basis of the shares. The computation also is more complicated, from a basis adjustment calculation perspective, if the carry-over basis exceeds the shares' fair market value on the date of gift. In this situation, the cost basis of the shares turns on the value of the shares when they are sold. If the shares eventually are sold for more than the carry-over basis, the carry-over basis applies. If the shares instead eventually are sold for less than the fair market value on the gift date, the basis of the shares is the fair market value on the gift date. If the shares are sold at a price between the carry-over basis and the fair market value, the basis of the shares is the sales price. As funds today typically do not compute any basis on gifted shares, this more complicated basis adjustment rule, which can remain unresolved for years, will present a new programming challenge.

Finally, a share re-registration may be a transfer for value. In this situation,

shares may be reregistered as compensation for services. The cost basis of the re-registered shares would be the agreed-upon compensation, which may or may not be the value on the date the fund is instructed to re-register the shares.

**Specific Statutory Recommendation.** The Institute recommends that the draft proposal be modified to provide default rules for re-registrations. Unless the fund has actual knowledge that shares have been inherited, funds would apply a default rule that treats as the cost basis of the re-registered

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shares the carry-over cost basis of the shares.<sup>9</sup> If the fund knows that the shares have been inherited, the default rule would 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. Funds should have clear statutory authority to override the default rule if the new account owner provides relevant additional information.

**Specific Committee Report Recommendation.** The Committee Report language we recommend for situations in which funds receive customer-provided information also should apply to share re-registrations. Likewise, the Institute's recommendations for determining the cost basis of pre-effective date shares also should apply if the transferred shares included pre-effective date shares. Finally, the Institute recommends that the Committee Report direct the IRS to amend reporting forms to allow funds to disclose that transferred shares have been included in a cost basis calculation. This disclosure would alert shareholders and the IRS that at least part of the information may have been subject to the default rule, and that the shareholder should review carefully the reported basis information to ensure its accuracy.

#### B. External Transfers

Transfers of mutual fund positions between financial institutions (mutual funds, broker-dealers, and banks) create additional cost basis reporting considerations. These transfers may be from a fund to a broker, from a broker to a fund, or from a broker to another broker. Because each transferor is a regulated financial institution, the transferee institution relies upon the transferred information regarding the mutual fund position. The recipient institution likewise typically would rely upon any cost basis information transferred with the mutual fund position.

The ability to rely upon information provided by a transferor institution is essential. If the transferee institution must verify transferred information, including cost basis information, the transferee institution likely will demand that the transferor institution provide

complete share lot activity for the life of the position. Complete share lot history would allow the recipient to calculate (or recalculate if a cost basis value also is provided) the cost basis using its own systems and procedures and be assured that the cost basis value meets its standards.

Transfers of complete share lot histories, however, will be impossible if some share lot history is unknown. This situation can arise for multiple reasons, many of which are discussed above. Other situations include (1) data previously administered by the transferor on a different system that is aggregated or otherwise becomes unavailable upon a system conversion, and (2) incomplete data received by the transferor from a prior transferor. Without the complete lot history, the recipient cannot recalculate or validate the cost basis to ensure that it is accurate.

9 The Treasury regulations contain a provision that prohibits a donee from using the average cost method if the carry-over basis of the gifted shares is less than the fair market value of the shares at the time of the gift. Treas. Reg. § 1.10121(e)(1)(ii). This regulation would need to be modified to permit funds to use a carry-over basis in these situations.

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Further, maintaining and transferring all share lot activity would be an expensive requirement for the industry. Lot history retention varies by firms but generally remains readily available only for a period of eighteen to twenty-five months. Outside that window, most fund companies calculate a cost basis value and related number of shares and retain that value with the account. The retained cost basis value is added to future lot activity to calculate basis. The lot data used to calculate that historical cost then is archived for storage. Absent the ability to rely on transferred cost basis values, the industry would have to support maintenance of all share lot history indefinitely. Systems also would need to be developed to manage the calculation and exception processing of share lots. Processes also would be needed to retrieve archived data for submission with every transfer, which would delay portability of positions from one institution to another.

Allowing a recipient to use cost basis information provided by external intermediaries without further review reduces the need for additional storage, streamlines the calculation process while achieving the additional reporting sought by the legislation, and avoids delay in transferring shareholder positions.

Specific Committee Report Recommendation. The Committee Report should clarify that transferees may rely upon information provided by transferors without any obligation to independently verify the information received. A transferee should be able to treat all shares for which cost basis information is not provided by the transferor as pre-effective date shares. If cost

basis information is not provided for shares, the transferee should request the cost basis information and then inform the shareholder and the IRS if the cost basis information subsequently is not transferred.

#### IV. Basis Adjustments

The Code contains several basis adjustment rules that funds must apply when calculating their shareholders' cost basis. Several rules may require funds to send amended Forms 1099 to shareholders months, even years, after the original Forms 1099 are sent, which we believe poses an unnecessary burden to shareholders, funds, and the IRS. We recommend statutory changes to eliminate unnecessary amended forms 1099 for wash sales, sales load basis deferrals, and returns of capital. These changes will not impair the statutory purposes of these provisions.

##### A. Wash Sales

The wash sale rules of section 1091 apply to a mutual fund investor who redeems fund shares and purchases new fund shares within 30 days of the redemption. Pursuant to these rules, any loss realized upon redemption is disallowed to the extent of the newly-purchased shares.<sup>10</sup> The disallowed loss then is added to the basis of the newly-purchased shares. If mutual funds are required to report shareholders' cost basis, application of the wash sale rules typically would require funds to send amended basis reports to shareholders who redeem fund shares in December at a loss and purchase fund shares in January within 30 days of the redemption (a "December/January wash sale").

<sup>10</sup> For example, if 1,000 shares are redeemed at a loss and 500 shares of the same fund are purchased less than 30 days later, half of the recognized loss is disallowed.

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If a mutual fund shareholder redeems shares in December of one calendar year and, pursuant to a dividend reinvestment program, purchases new shares in January of the next calendar year, the wash sale rules would apply to the extent of the newly-purchased shares. Thus, any disallowed loss would be added to the cost basis of the shares purchased. The mutual fund, however, already would have provided basis information to the shareholder for the first calendar year. The fund thus would need to send amended Forms 1099 to the shareholder in February. These types of December/January wash sales should be exempt from the wash sale rules. Automatic share purchases through dividend reinvestment plans are not the type of abusive transaction for which section 1091 was enacted. Further, compliance costs to funds, shareholders, and the IRS of processing amended Forms 1099 most likely would outweigh the benefits.

Similar burden issues arise when the dollar amount of a December/January wash sale is small. To address these situations, a de minimis exception should be provided for applying the wash sale rule. The Institute proposes that the wash sale rule not apply to December/January wash sales if the amount of the otherwise-disallowed loss is \$25 or less.

Specific Statutory Recommendation. Section 1091 should be amended to disregard any shares (a) purchased in January of the year following the year in which shares were redeemed at a loss from an open-end regulated investment company on which basis reporting is required under the proposed amendment to section 6045, provided that (b) either (i) the shares were purchased pursuant to a dividend reinvestment plan or (ii) the amount of the loss that would be disallowed by section 1091 is \$25 or less.

#### B. Sales Load Basis Deferrals

Special basis rules apply if a fund shareholder incurs a load charge in acquiring shares in one fund ("Fund A"), disposes of Fund A shares within 90 days after they are acquired, and on any date thereafter acquires shares in another fund ("Fund B") for which the otherwise applicable load is reduced or waived. In this situation, section 852(f) provides that the load paid on the Fund A shares will be included in the basis of the Fund B shares, rather than the Fund A shares, to the extent that the load paid on the Fund B shares has been reduced or waived. This so-called sales load basis deferral rule is designed to prevent shareholders from effectively deducting the load charge prior to the disposition of the Fund B shares.

Application of the sales load basis deferral rule to mutual fund cost basis reporting could create significant tax administration difficulties by requiring funds to send amended cost basis reports months or years after the original reports were sent and shareholder tax returns were filed. For example, a shareholder might purchase and redeem Fund A shares within 90 days and then invest the proceeds in a no-load fund, such as a money market fund. The shareholder thus would not have acquired shares in another fund at a reduced or waived load by the end of the calendar year in which the redemption occurred. In this event, the application of section 852(f) would remain suspended, and the fund would be required to report the load in the basis of the Fund A shares.

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If the shareholder subsequently acquired shares in Fund B and the applicable sales load on the Fund B shares were reduced or waived, the sales load basis deferral rule would retroactively reduce the basis of the Fund A shares by the amount of the reduced or waived load and include that amount in the

basis of the Fund B shares. As a result, the fund would be required to send to the shareholder an amended Form 1099, and the shareholder would have to amend its tax return for the year in which the Fund A shares were sold. Because there currently is no limit on the retroactive application of section 852(f), this amendment could occur months or years after the Fund A shares were redeemed.

The Institute's proposal would eliminate this problem by limiting the application of section 852(f) to acquisitions of Fund B shares that occur before January 31 of the calendar year following the calendar year in which the Fund A shares were redeemed. If the Fund B shares were acquired before this date, the fund would be able to apply the sales load basis deferral rule to the shareholder's cost basis before providing cost basis information to the shareholder, and no amended form 1099 would be required.

Specific Statutory Recommendation. Section 852(f) should be amended to provide that the load basis deferral rule would not apply if a fund shareholder acquired the new shares in Fund B after January 31 of the calendar year following the calendar year in which the shareholder disposed of its shares in Fund A.

#### C. Returns of Capital

Under IRS regulations, a company that returns capital during a taxable year (because distributions for the taxable year exceed earnings and profits) must allocate the return of capital pro rata over all distributions made during that taxable year. Every shareholder in a company must reduce cost basis in each share held on the date a return of capital distribution is made.

The return of capital rule can retroactively adjust cost basis several months after cost basis would have been reported and shareholders' tax returns would have been filed. Amending cost basis statements to reflect returns of capital would be extremely confusing to fund shareholders.

Example. Assume a fund with a taxable year ending October 31 of Year 2 that distributes 10 cents per share each month; the total distributions for the taxable year are \$1.20 per share. If the fund's earnings and profits for the fiscal year were only 60 cents per share, half of each monthly distribution (or 5 cents per distribution) would be a return of capital.

The cost basis of each share in the fund would be reduced by 5 cents every month during the taxable year. Thus, if a shareholder held 100 shares during each month of the taxable year, the cost basis of these shares would be reduced by \$5.00 each month. However, the cost basis adjustments could not be made until after the close of the fund's taxable year (i.e., after October 31 of Year 2 in this example).

In the example above, if a shareholder redeemed shares in December of Year 1, after the November and December Year 1 distributions were received, the cost basis of the shares

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redeemed in December would be overstated by 10 cents per share after application, over ten months later, of the return of capital adjustment.

We recommend that a fund generally allocate returns of capital only to distributions made during the portion of the fund's taxable year occurring during the calendar year in which the taxable year ends. Thus, in the example above, the 60-cent return of capital would be allocated pro rata (6 cents per share) over the 10 distributions occurring between January and October. No portion of the return of capital would be allocated to the portion of the taxable year arising in the prior calendar year, unless the amount of capital returned exceeded the total amount of distributions made during the portion of the taxable year falling in the second calendar year. In this case, any excess return of capital would be allocated pro rata over the distributions made during the prior calendar year.

Specific Statutory Recommendation. Section 316(b) should be amended to provide that funds may allocate returns of capital first to distributions made during the portion of the fund's taxable year occurring during the calendar year in which the taxable year ends.

#### D. Amendment Made by Staff Draft to Section 1012

The staff's draft amends section 1012 to provide that "[t]he basis of any applicable security reportable under section 6045(g) shall be determined on an account by account method."

This amendment could be interpreted to apply all cost basis adjustment rules (e.g., the wash sale and straddle rules) on an account-by-account basis.<sup>11</sup> Alternatively, the change could be intended to protect brokers from liability for incorrect basis reporting when a taxpayer engages in a wash sale or a straddle through transactions in two different accounts, perhaps with different brokers.<sup>12</sup> More narrowly, the intent of this change could be to clarify that the FIFO method should be applied on an account-by-account basis.<sup>13</sup> Clarification of this amendment is needed.

<sup>11</sup> For example, if a taxpayer engages in a wash sale transaction through different brokers, the wash sale rules of section 1091 may not apply. If not, the wash sale rule effectively has been repealed. If section 1091 does apply, it is not clear that the taxpayer can add to the cost basis of the newly acquired shares in one account the amount of the disallowed loss suffered in the other account, because, under this amendment, cost basis is calculated on an account-by-account basis. If this were the case, the loss would be disallowed permanently.

12 If this were the intent, the staff's draft should be revised to make this change to the reporting requirements under section 6045(g), rather than amending section 1012.

13 The Treasury regulations under section 1012, rather than the statute itself, should be amended if this were the intent of the proposed amendment.

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## V. Other Issues

### A. Holding Period

The staff's draft also requires that brokers provide "such information as necessary to determine the customer's holding period with respect to" the shares sold or redeemed. Funds' reporting obligations with respect to holding periods should be clarified.

Funds currently provide holding period information to redeeming shareholders by reporting "short-term" or "long-term" gain or loss. Funds typically retain lot history information on their most accessible computer systems. In general, lot histories are kept on-line for 12 to 18 months, although, in practice, such records may not be archived until after 24 to 30 months. Requiring funds to report purchase dates for each share lot would require significant amounts of data storage and maintenance, not to mention the increased amount of data that would have to be added to the Forms 1099.

Specific Committee Report Recommendation. We recommend that the Committee Report clarify that the holding period need be reported only as either "short-term" (held for 12 months or less) or "long-term" (held for more than 12 months). In addition, the Committee Report should clarify that funds may rely upon the holding period information provided to them by another party in connection with a transfer of shares.

### B. Electronic Transmittal

The staff's draft provides that, when shares are transferred to a broker, the transferring broker "shall furnish ... a written statement in such manner and setting forth such information as the Secretary may by regulations prescribe."

Specific Committee Report Recommendation. We recommend that the Committee Report clarify that the written statement requirement may be satisfied by electronic transmittal. Because large amounts of data may need to be moved from one broker to another, permitting electronic transmittal will greatly ease, and increase the speed of, this transfer of information.

### C. Extended Reporting Date

The draft proposal will impose significant new responsibilities on funds in January, at the height of tax-reporting season. The current January 31 tax reporting deadline will be particularly difficult to meet if this legislation is enacted.

Specific Statutory Recommendation. The Institute recommends that the 15-day tax reporting deadline extension (from January 31 to February 15) contained in S. 636, The Reduce Wasteful Tax Forms Act of 2007, introduced by Senator Charles Schumer earlier this year, be added to the staff's draft. The additional fifteen days would assist funds greatly in satisfying their tax reporting obligations on a timely basis and result in fewer amended Forms 1099.

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#### VI. Conclusion

The Institute strongly support efforts, such as cost basis reporting, to assist shareholders with their tax compliance obligations. In developing cost basis reporting legislation, it is imperative that:

- any mandatory basis-reporting regime be administrable and effective for shareholders, funds, brokers and other distributors, and the government;
  - sufficient time be provided to ensure that the necessary programming and systems challenges are addressed effectively; and
  - the current-law flexibility that allows mutual funds and their shareholders to compute cost basis under any available method be maintained.
- We look forward to continuing our discussions with the Committee staff and working with all relevant parties as this legislation moves forward.

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