ICI Letter Supports, With Critical Amendments, Cost-Basis Reporting Legislation, December 2007

December 6, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
511 Hart Senate Office Building
Washington, DC 20510

The Honorable Charles E. Grassley
Ranking Minority Member
Committee on Finance
United States Senate
135 Hart Senate Office Building
Washington, DC 20510

RE: Mandatory Cost-Basis Reporting for Mutual Funds

Dear Chairman Baucus and Ranking Minority Member Grassley:

The Investment Company Institute,[1] on behalf of mutual funds and their shareholders, urges the Senate to accept, with a few critical amendments, the basis reporting provisions of H.R. 3996, the "Tax Reduction and Reform Act of 2007." We appreciate greatly the Committee's responsiveness to the concerns expressed by the mutual fund industry and others that the basis reporting legislation be workable for brokers and funds, shareholders, and the government. This letter addresses the remaining several issues that will help ensure an administrable system.

As an initial matter, we must emphasize the importance of the February 15 reporting deadline included in the House bill. This provision is critical to the effective implementation of an administrable cost-basis reporting regime.

We recommend that any cost-basis reporting provision address situations in which a cost-basis statement must be amended months or years after it has been sent to taxpayers because of certain transactions or events that take place after the fund shares are sold. The most prominent example, which could cause millions of cost-basis statements to be amended many months after individuals file their tax returns, involves so-called "returns of capital." Sending such amended statements, often for de minimis amounts, will cause shareholder confusion and outrage (especially if shareholders are required to amend their tax returns). In our discussions with the Committee's staff, the Institute has recommended solutions that would avoid such situations without affecting the intent of the Internal Revenue Code.[2] Our proposed fix for the return of capital issue is described in detail in this letter's enclosed appendix, which we already have shared with your staffs.

The Institute recommends several other technical amendments (also described in the enclosed appendix) that are necessary for the proposed legislation to work properly. Without these fixes, the legislation will create shareholder confusion and unnecessary operational problems for funds, their service providers, and other industry participants when they begin to implement the basis reporting requirements.

The Institute appreciates the Committee's willingness to work with the Institute and the mutual fund industry in the past to address many of the complex issues raised by a mandatory basis reporting regime. The amendments that we have recommended will resolve many of the outstanding issues in H.R. 3996.

We look forward to working with you further as this legislation moves forward. If you have any questions, please contact me at

202/326-5901, or Dan Crowley, the Institute's Chief Government Affairs Officer, at 202/326-5962.

Sincerely,

Paul Schott Stevens
President and CEO

APPENDIX

Returns of Capital

The most important change urged by the Institute is an amendment of the provisions under section 316(b) of the Internal Revenue Code regarding returns of capital. This change is essential to prevent unnecessary amended IRS Forms 1099 to millions of fund shareholders. Because mutual funds have fiscal years that often vary from the calendar year, funds may be required to send amended Forms 1099 to their shareholders months after the shareholders have filed their tax returns for the affected tax year.

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. Some of these distributions may have occurred in a prior calendar year for which shareholders have already filed their tax returns. Under the current rules, however, funds must send an amended Form 1099 for those distributions.

The return of capital rule thus 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 this example, 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 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.

The Institute recommends that H.R. 3996 be amended by inserting on page 103, after line 10, the following:

"(f) MODIFICATION OF DIVIDEND DEFINITION FOR RETURNS OF CAPITAL BY REGULATED INVESTMENT COMPANIES – Section 316(b) is amended by adding at the end thereof the following new paragraph (b)(4):

'(4) RETURNS OF CAPITAL BY A REGULATED INVESTMENT COMPANY.–

If a regulated investment company (as defined in section 851) with a taxable year other than the calendar year makes distributions during its taxable year (other than a distribution under section 855 that relates to the preceding taxable year) that exceed the company's current and accumulated earnings and profits, such earnings and profits shall be allocated first to distributions made by the company during the portion of its taxable year ending on December 31 as if such period were a separate taxable year.'

Technical Amendments

1. Treatment of Shares in Existing Accounts as Separate Accounts.

In response to industry concerns regarding the effective date, H.R. 3996 contains two separate effective dates for open-end funds (January 1, 2009, and January 1, 2011), thus giving funds additional time in which to fully comply with the proposed changes. The bill also contains a provision allowing funds to treat pre-effective date shares and post-effective date shares in an existing account as two separate accounts; this provision is necessary to deal with the issues raised by the average cost method used by mutual funds. The separate account provision as currently written, however, does not work with the two-tiered effective date and creates more complexity.

To correct this problem, two separate changes are necessary. First, the separate account provision should allow funds to treat an existing account as three separate accounts; these accounts, which would be treated as separate accounts within an existing account, would be for shares acquired: (1) before January 1, 2009; (2) after December 31, 2008 and before January 1, 2011; and (3) on or after January 1, 2011. Second, funds should be permitted to combine all shares held in either two or three of the separate accounts as within the same account (for purposes of treating previously-acquired shares as covered securities subject to reporting). This second change, among other things, would permit funds to combine all shares acquired before January 1, 2011 as within one account (and calculate cost basis using one method), while maintaining a shareholder's ability to select another cost basis method for shares acquired after December 31, 2010.

The Institute recommends the following changes to H.R. 3996:

1. On page 90, strike lines 1 – 5 and insert the following:

"(A) IN GENERAL. – Except as provided in subparagraph (B), any stock in an open-end fund acquired before January 1, 2009, any stock in an open-end fund acquired on or after such date and before January 1, 2011, and any stock in an open-end fund acquired on or after January 1, 2011, each shall be treated as a separate account."

2. On page 90, line 13, strike "any" and replace with "all".

3. On page 90, line 15, insert "two or more separate accounts in" after "all stock in."

2. Gifted and Inherited Shares.

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).

The Institute recommends the following changes to H.R. 3996:

1. On page 92, insert the following after line 23:

"(C) DEFAULT RULE FOR TRANSFERRED SECURITIES. – For purposes of the information described in paragraph (2), the adjusted basis of a specified security that a customer of a broker acquires by gift or other transfer from another customer of a broker (other than through a market transaction executed by a broker) shall be, unless the customer informs the broker otherwise:

(i) in the case of a transfer other than a transfer that the broker knows is by reason of death, the same as it would be in the hands of the transferor; and

(ii) in the case of a transfer that the broker knows was by reason of death, (i) the fair market value of the specified security at the date of the decedent's death, or (ii)if the specified security was jointly owned by the transferee and the decedent, the transferee's existing basis increased by the fair market value of the interest in the specified security acquired from the decedent at the date of the decedent's death."

2. On page 92, line 24, strike "(C)" and replace with "(D)."

3. Similar Treatment for All Regulated Investment Companies.
H.R. 3996 currently contains basis reporting rules for open-end funds that differ from those for stock in other corporations. The definition of "open-end funds" for this purpose excludes closed-end funds and exchange-traded funds ("ETFs"), thus treating shares in those vehicles as regular equities. Closed-end funds and ETFs, however, are permitted to use the same basis calculation methods under section 1012 that are permitted for open-end funds. Therefore, the Institute recommends that the provisions relating to open-end funds be amended to apply to all regulated investment companies, as defined in section 851.

The Institute recommends the following changes to H.R. 3996:

1. On page 90, line 14 – 15, strike “an open-end fund” and replace with “a regulated investment company, as defined in section 851.”

2. On page 90, line 21, strike “an open-end fund” and replace with “a regulated investment company.”

2. On page 91, line 2, strike “an open-end fund” and replace with “a regulated investment company.”

3. On page 93, strike likes 7 – 13.

4. On page 96, line 24, strike “OPEN-END FUNDS” and replace with “regulated INVESTMENT COMPANIES.”

5. On page 97, lines 2 – 3, strike “an open-end fund” and replace with “a regulated investment company.”

6. On page 97, line 6, strike “OPEN-END FUND” and replace with “regulated INVESTMENT COMPANY.”

7. On page 97, lines 7 – 8, strike “an open-end fund,” and replace with “a regulated investment company.”

8. On page 97, line 13, strike “fund” and replace with “company.”

9. On page 97, line 15, strike “fund” and replace with “company.”

ENDNOTES

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.98 trillion and serve almost 90 million shareholders.

[2] These recommendations are discussed on pages 11 through 14 of the Institute’s June 28 submission to the Committee’s staff on cost-basis reporting.

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