

By electronic delivery

November 30, 2006

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Democrat
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Grassley and Senator Baucus:

The Securities Industry and Financial Markets Association (SIFMA)¹ appreciates the opportunity to comment on the new discussion option from the Joint Committee on Taxation to require brokers to report to the IRS and to investors the adjusted basis of publicly traded securities that are sold during the preceding year. The securities industry strongly supports efforts to close the tax gap, and is committed to working with your Committee as you consider new basis reporting requirements. We would like to thank you, your staffs, the staff of the Joint Committee on Taxation, and the GAO for the continuing careful examination of this topic and the commitment to work with the private sector to improve compliance in this area by the most effective means possible.

After providing some background concerning current basis tracking practices in our industry, this comment letter sets forth some specific recommendations as to the features that we believe should be included in any new basis reporting requirement. We believe that adoption of these recommendations would help meet the goal of developing a basis reporting

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

system that substantially reduces the under-reporting of capital gains by taxpayers without imposing costs on both the government and the private sector that would yield little or no tax administration benefits.

Background

This overview of the industry's existing efforts in tracking basis and some of the challenges faced is intended to provide helpful context for consideration of our recommendations that follow.

In general. Today, most of the largest securities dealers track some basis information for at least a portion of their customers. Nevertheless, basis reporting capabilities have been many years in development and remain incomplete. Many brokers turn to outside service providers for some or all of their basis tracking.

Industry reporting is “best efforts.” Despite the desire of firms to provide customers with basis information, today these systems are most accurately described as providing "best efforts" services rather than as providing investors with reliably correct basis numbers. In addition to the significant gaps in capabilities outlined below, there are many limitations relating to brokers' dependence on third parties for the information necessary to determine basis. Most significantly, brokers often do not have access to adequate tax information from issuers, who may not provide clear or widely available information with respect to their many corporate actions (e.g., the character of distributions, taxability of mergers or acquisitions, relative valuations of different classes of securities). Brokers also often need to rely on investors or their advisors to self-report with respect to the basis of securities acquired elsewhere. In the case of transferred accounts, the lack of standardization of basis tracking practices within the industry makes it impossible for the transferee broker to know the quality of the basis information it is receiving from the transferor broker. Many brokers today also rely on third-party service providers to perform many basis tracking tasks.

In addition to needing to rely on others for certain key information, there may be other transactions that an investor has entered into, or investment elections the investor may have chosen, that impact basis but that are only known to the investor. Further, brokers commonly face substantive tax law complexity or ambiguity affecting basis determinations. For all of these reasons, current basis information provided to customers represents a broker's best efforts but is accompanied by strong recommendations that customers should consult with their tax professionals before preparing their tax returns.

Industry capabilities most developed for common stocks. The Securities Industry Association (one of SIFMA's predecessor organizations) conducted an informal survey last year of the members of its Committee on Tax

Compliance and Administration with respect to their basis tracking practices. We found that basis tracking services were significantly more developed in the industry as a whole with respect to common stocks than with respect to other types of investments, such as many types of fixed income securities. We believe this is because common stocks generally require fewer basis adjustments and there is less opportunity for interpretation related to transactions that require adjustments to cost basis for these securities.

Gaps remain in even the best reporting systems. Currently even the largest brokers generally do not attempt to make certain types of basis adjustments due to the complexity involved. Further, with respect to certain types of investments, the uncertainties involved in reaching a basis determination are so significant that firms either do not attempt to carry a basis number or the number carried is not particularly useful. The following are some of the most significant gaps in most brokers' existing basis tracking capabilities:

(i) Adjustments to basis resulting from post-year-end reclassifications of mutual fund, REIT and other distributions. Almost no brokers attempt to capture adjustments to basis when mutual funds, REITs or other issuers make post-year-end recharacterizations of prior distributions. These reclassifications of their distributions often arrive weeks or even months after December 31st, and picking up this late basis information would require the chronological unwinding of intervening basis adjustments for both open and closed investor positions.

(ii) Option premiums. Many brokers do not capture the effects of option premium payments on the basis of the underlying investments. Linking the two is a very complex undertaking, particularly when there are multiple tax lots. This is in part because options trade in different markets than the underlying securities, and the relevant broker systems carrying the data for each type of investment may have been developed independently without tax considerations in mind. These systems may not be easy to link with each other, and/or with tax reporting systems, to accomplish the necessary basis reporting tasks. It should be noted that with respect to the related issue of gross proceeds reporting on options transactions, the IRS has recognized the complexity associated with options and has reserved on the issue in the regulations. Reg. sec. 1.6045-1(m).

(iii) Complex financial instruments. Brokers often do not track basis for complex financial instruments containing a combination of debt and equity features (and sometimes other features, such as contract rights). These instruments generally involve significant factual and/or legal uncertainties affecting the calculation of basis, calling into question the reliability and therefore the utility of any basis number produced by the broker. Mandatory issuer reporting with respect to the probable tax consequences of these instruments as recommended below could solve some of these

problems, but many other difficulties would remain. The relative valuations of the components of these investments that are necessary to allocate basis among them are often unknown. Further, there are significant mechanical difficulties tracking basis for components of an investment when it has only a single CUSIP number.

(iv) Foreign securities. Industry basis reporting practices with respect to foreign securities are not as well-developed as those relating to domestic securities, primarily because these investments raise a disproportionate number of factual and legal questions that are very difficult or impossible for brokers to resolve. Brokers typically do not have reliable sources of information concerning the U.S. tax treatment of corporate actions of foreign issuers, which is necessary to determine basis. Often there is no prospectus to consult, but only an outdated or abbreviated form filed with the SEC. Publicly obtainable information may not be in English, and may indicate only the foreign tax treatment of the transaction. Further, there are not established channels of communication between many foreign issuers and U.S. brokers, and thus brokers may not even receive notice that a foreign issuer has engaged in a corporate action that might impact basis. Foreign issuers also do not use U.S. GAAP, often making any conclusions concerning earnings and profits unreliable. Fair market values can also be difficult to obtain when needed.

(v) Bond premium and bond discount. Most broker basis tracking systems do not capture bond premium or bond discount adjustments to basis with respect to taxable bonds due to the many complexities involved. The default rule is that bond premium on these securities is not amortized unless a taxpayer makes an election to do so on his or her tax return. Brokers, however, generally have no way of knowing if clients have made such an election. Original issue discount increases an investor's cost basis in a taxable bond, but is adjusted downward to the extent of premium amortization, if any. Additionally, complex variations of the original issue discount basis adjustment rules apply to securities that are not issued at a discount, such as Treasury Inflation Protection Securities (TIPS), index-linked instruments, and contingent deferred debt instruments, some of which can result in negative basis adjustments.

Recommendations

We believe that clear rules and sufficient lead time to adapt to any new requirements are essential to the development of a reliable and uniform basis reporting system. In order to move to an effective system with a minimum of unnecessary costs and uncertainties for investors, tax administrators, brokers

and other affected financial market participants, we suggest adopting the following recommendations.

1. Provide statutory authority to implement in phases.

We strongly believe that new basis reporting requirements would be most effectively implemented in stages. This is because a great distance remains to be covered in getting from today's "best efforts" reporting environment to a uniform and much more accurate reporting system supported by a number of types of financial market participants. We believe it would be a serious mistake to assume that all aspects of a well-designed basis reporting system could come together at the same time over a relatively short implementation period without imposing significant unnecessary costs on both tax administrators and the private sector. We recommend that you consider providing the Secretary of the Treasury with the authority to implement new reporting requirements in phases, and to determine when to move from phase to phase as government and private sector capabilities permit. We believe this will result in rules better designed to meet tax compliance needs, increase the reliability of the basis reporting, and greatly reduce costs, disruptions, and uncertainty for tax administrators, brokers and investors alike.

In particular, we recommend that any new requirements be extended first to U.S. common stocks and mutual fund shares, exclusive of certain complex basis adjustments, such as adjustments to basis resulting from post-year-end reclassifications of distributions from taxable income to return of capital (or vice versa) by mutual funds, REITs and other issuers. (See discussion in Recommendation 2, below.) This is because existing industry capabilities are most developed with respect to these investments, the issues are better understood, and this should make it easier to develop and put in place new standardized reporting practices. With sound basic rules developed for these investments, it should be much easier to then tackle the problems associated with making the more complex adjustments for these securities, as well as to begin phasing in basis reporting requirements for other types of investments.

We believe that this recommendation is consistent with the Committee's objectives. From a tax compliance perspective, this approach would still ensure that, based on the GAO's June 2006 report, the largest source of underreporting of capital gains on securities would be focused on and addressed first.²

² The Government Accountability Office found that "of those taxpayers who misreported securities sales, an estimated 97 percent misreported gains or losses from the sales of stocks and mutual funds, while an estimated 5 percent misreported bonds, options, or futures." Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges are Addressed, GAO Report to the Senate Finance Committee, June 2006, p. 11.

2. Provide statutory authority to waive or modify reporting requirements in some cases.

We recommend that the Secretary of the Treasury be given the statutory authority to conclude, where appropriate, that brokers should not be required to track a particular type of basis adjustment or to report basis with respect to some types of investments. Ideally, the authority should be flexible enough to provide room to deal with a wide range of unanticipated issues and circumstances. Legislation could set forth the appropriate parameters for the Secretary to apply in making this determination.

We believe that providing the Secretary with this type of authority is essential in order to ensure that any new reporting requirements strike the right balance between reporting accuracy and the costs of attempting to arrive at a more accurate basis number. This is particularly true given that the definition of "securities" in the Joint Committee proposal is extremely broad. Such a broad definition may be generally appropriate when extending authority to the Secretary of the Treasury to require basis reporting. However, if the intent is to provide by statute that basis reporting is required, a broad definition must be coupled with appropriate authority to modify or waive particular basis tracking efforts if tax administrators reasonably conclude that compliance needs can be met at significantly reduced costs by the reporting of information falling short of adjusted basis for certain assets or events.

An important example of a case in which this flexibility is needed concerns the problem that brokers face every year with new tax information arriving after the end of the year from mutual funds, REITs and occasionally other issuers. The late-arriving information corrects information previously supplied to brokers concerning the tax character of the issuer's distributions for the year. The primary cause of the late arrival of the information is the underlying tax rules; it is generally not the fault of the issuer. Under current practices, even the largest brokers typically do not track such post-year-end basis information due to the complexity of doing so. It might be reasonable for the IRS to conclude that the costs of requiring this type of basis adjustment would outweigh the tax administration benefits, and the statute should permit this result.

Similarly, the IRS might determine that basis tracking with respect to certain foreign securities or complex investments would not be necessary in order to achieve substantial compliance gains. Perhaps these investments could be handled more cost effectively by requiring brokers to report something other than basis, such as original cost and/or some type of indicator of investment type. Allowing the IRS to make these types of practical judgments upon implementation should significantly improve the allocation of finite tax compliance resources for both the IRS and the private sector.

Finally, as a means of addressing certain types of complexities, you may want to consider providing in either the statute or in the legislative history that certain specified items potentially impacting basis, such as wash sales or investor-level elections, are not intended to be encompassed by broker reporting. This would ease implementation of any new requirements for both the IRS and the private sector.

3. Limit reporting requirements to individual investors.

We recommend that any new basis reporting requirements be limited to reporting with respect to individual investors. This would appropriately tailor reporting obligations to the specific tax gap problem that has been identified by the GAO. Brokers today report gross proceeds not only to individuals but also to partnerships and other non-corporate entities. However, we do not believe tax compliance would be improved by having brokers also track basis for non-individuals. The partnerships and other entities that today receive reporting of gross proceeds are generally sophisticated and well-equipped to track the basis of the investments they hold. Further, basis tracking efforts by brokers would be duplicative of the efforts already undertaken by these partnerships and other entities, which are in a better position to determine basis, because of entity-level facts, than brokers are. In addition to the duplicative costs, the two sets of numbers would inevitably present reconciliation issues that could be costly to resolve yet would produce no tax administration benefits.

4. Basis reporting requirements should not be tied to current requirements to report gross proceeds.

We agree with the Joint Committee proposal that in many cases it would make sense conceptually for basis reporting and gross proceeds reporting to work in tandem. However, we believe new basis reporting requirements should not be tied directly to current requirements to report gross proceeds. Gross proceeds reporting is simply much easier to accomplish than basis reporting and therefore would appropriately be broader in scope than basis reporting. Further, tying basis reporting to current gross proceeds reporting rules does not work mechanically in some significant cases. For example, with respect to short sales, gross proceeds reporting is required at the time of the short sale, but there is no basis to report at that time. Basis can be determined only once the security is purchased back to close out the short sale. In the case of options, as another example, it is unclear what is intended under the Joint Committee proposal, but currently there is no gross proceeds reporting with respect to sales of options. Treas. Reg. sec. 1.6045-1(m).

5. Exclude partnership interests and other beneficial ownership interests from basis reporting requirements.

We recommend that partnership interests and other beneficial ownership interests be excluded from the scope of any new basis reporting requirements. Basis in these investments is adjusted after acquisition to reflect many entity-level events. For example, the basis in a partnership interest is adjusted to reflect the partner's pro rata share of income from the partnership, whether or not distributed, and only the partnership is in the position to track and report this income to partners. Further, the partnership reports each partner's share of the income of the partnership directly to the partner long after the current January 31st deadline for broker reporting. In the case of widely held fixed investment trusts, which are treated as grantor trusts, the IRS has already provided rules relating to basis reporting responsibilities, and any new basis reporting requirements should not layer on top of these new rules. Brokers are simply not the appropriate parties to report basis to investors with respect to these investments.

6. Mandate issuer reporting with respect to corporate actions before basis reporting takes effect.

SIFMA strongly agrees that it is critical to require issuers of securities to report to the financial community the tax consequences of their corporate actions *before any new basis reporting obligations take effect. The importance of this ordering of new issuer and broker reporting requirements cannot be overstated.*

Issuers today are not required to report to the IRS or make widely available to the financial community the probable tax consequences of their corporate actions. This lack of issuer reporting both compromises the reliability of the basis data that brokers provide to customers and greatly increases the costs to investors and their brokers of calculating basis. Congress must ensure that any new basis reporting system is developed in the most reliable and cost effective manner possible. For this reason, issuer reporting requirements are an absolutely necessary *prerequisite* to a new basis reporting regime.

Tax administrators have a crucial interest in issuer reporting taking effect before the onset of any new broker reporting requirements. Issuers are the sole source of consistently reliable information with respect to their own transactions, and are in the best position to judge the tax consequences of their corporate actions, having access to all of the relevant factual and legal information. Both investors and the IRS need to be able to obtain the most reliable basis information possible if basis reporting is to be as effective as possible in reducing capitals gains noncompliance. Further, in the absence of the best information possible, there will be more controversies on audit, to the detriment of both investors and the IRS.

If brokers were to be tasked with basis reporting before issuers were compelled to disclose the probable tax consequences of their corporate actions, the inevitable result would be greatly increased implementation costs and confusion. Brokers would be forced to struggle, as they do today, to marshal dispersed, often ambiguous information on the tax consequences of issuers' corporate actions. In some cases, holders of the same security at more than one broker could have different adjustments to basis made by two different firms reaching different conclusions about the appropriate tax treatment of a corporate action.

To provide an order of magnitude of the costs, in 2005 there were over 8,900 corporate actions requiring special attention to determine their potential impact on basis. This total is exclusive of cash dividends, and includes transactions such as redemptions, stock splits, recapitalizations, mergers, and acquisitions. The very substantial costs to brokers and investors of seeking out basis information could be minimized easily by putting in place clear, standardized procedures for the tax reporting community to obtain tax information from issuers upon which they can rely.

Congress has given the IRS broad authority to mandate issuer reporting with respect to their corporate actions. I.R.C. Section 6043(c), Section 6043A (enacted in 2004). During the 2002-2005 period, the IRS worked in close cooperation with SIA (one of SIFMA's predecessor organizations) to develop very effective proposed regulations that, if finalized, would have instituted effective issuer reporting with respect to a broad range of corporate actions. Had these regulations been finalized, they would have immediately improved the quality of the basis information maintained by brokers. However, they were not finalized, and only the temporary portion of the regulations relating to the reporting of inversion transactions was finalized late in 2005. *For basis reporting to be accurate and avoid imposing substantial unnecessary costs on brokers, Congress must ensure that the IRS puts in place effective issuer reporting rules like those in the proposed Section 6043(c) regulations before new basis reporting requirements take effect.*

7. Require transfer of basis information upon account transfers and other securities transfers.

As recommended in the Joint Committee's proposal, we believe that for any basis reporting system to be effective, all transferor brokers must have a statutory obligation to supply basis information to transferee brokers when customers move their accounts. We do not believe that the statute should specify how this information must be provided. Instead, IRS guidance would need to establish uniform rules that we anticipate would provide for electronic transfer using a standardized format in most cases. We also agree that taxpayers, where appropriate, should be required to provide accurate basis information to the broker when a security is first transferred into an account (for

example, as a result of a gift or a bequest). We also recommend that the Committee consider extending such a requirement to other entities where appropriate, such as issuers or their transfer agents in the case of employee stock purchase plans.

8. *Allow brokers to rely on information provided by third parties.*

Similarly, SIFMA strongly supports the Joint Committee proposal to permit brokers to rely on information provided by third parties, such as issuers specifying the tax consequences of their corporate actions, transferring brokers providing information to a transferee broker on the occasion of an investor moving his or her account, and taxpayers supplying basis information with respect to investments they acquired elsewhere. This is critical, since brokers will always be dependent upon the information they are provided and should be entitled to presume that the information is correct. We also support the recommendation that brokers report to the IRS the cases in which the source of basis information is a third party. Given that many brokers will not be in a position to develop in-house basis reporting capabilities, at least in the early years, we also believe it is necessary to clarify the circumstances under which brokers should be entitled to rely on third-party service providers in meeting their basis reporting obligations.

9. *Consider means of minimizing mismatches between 1099s and tax returns.*

We anticipate that any new basis reporting requirement would lead to numerous situations in which the basis number provided by the broker on Form 1099 will not match the basis number shown by the investor on his or her return, even though neither the investor nor the broker has done anything incorrectly. The potential for mismatching will arise because a broker often will not have all of the information necessary to accurately determine basis or will not have the capability of making the complex adjustments. For example:

(i) Redemptions. The characterization of a redemption distribution as either a sale or a dividend will impact an investor's basis. However, brokers will not have the information necessary to perform the shareholder-level analysis required under Section 302 of the Internal Revenue Code to determine the proper characterization of the distribution.

(ii) Determination of basis of securities sold when there are multiple lots. Investors are generally permitted to use either the FIFO method or the specific identification method to determine the basis of securities sold when multiple lots are held. Treas. Reg. sec. 1.1012-1. Many brokers currently do not have the ability to provide investors with basis information using the specific identification method. The Joint Committee proposal to modify the basis computation rules in section 1.1012-1 of the Treasury

Regulations to apply on an account-by-account basis may be warranted but needs further discussion.

(iii) Taxpayer-level elections. A broker may not be advised of an election that the investor has made that impacts basis, such as an election to amortize bond premium.

While we do not have a specific recommendation for how to best address the problem of mismatches, we urge the Committee to consider means of minimizing this problem and would welcome the opportunity to work with the Committee to consider likely sources of mismatches and possible approaches to minimizing them.

10. Provide enhanced transition relief for small brokers and other brokers facing particular challenges.

SIFMA does not believe that fully phased in tax reporting requirements should vary among brokers based upon their size or business model. However, small brokers and brokers that are not full service brokers could face greater obstacles in meeting new basis reporting requirements than other brokers. For this reason, we believe they should be provided more generous penalty relief and more time to develop basis reporting capabilities in-house or establish a relationship with a third-party service provider to meet their new reporting obligations, so long as they are making reasonable efforts to meet new requirements.

11. Tax-favored arrangements.

We believe basis reporting should not be required at this time with respect to transactions involving qualified retirement plans, individual retirement arrangements, qualified tuition plans, and similar tax-favored arrangements. The benefits of such reporting are not clear in light of existing reporting requirements, and a full examination of benefits and costs should precede any proposal concerning these arrangements.

12. Reporting to the IRS.

The Joint Committee report asks for comments on whether brokers should report to the IRS a total basis number for all transactions of an investor during the past year as opposed to reporting basis information to the IRS on a transaction-by-transaction basis. SIFMA believes that reporting a single aggregate basis number to the IRS but continuing to report on a transaction-by-transaction basis to investors would lead to substantial confusion and could undermine the goal of using information reporting to improve compliance. Further, such a regime could require the IRS to ask each investor to produce the very information that the IRS could have obtained in a less intrusive and more

cost effective manner from the broker at the same time the information was provided to the investor.

13. Effective date.

Compliance with basis reporting is going to be a major undertaking, even for those firms that have already invested substantial resources in providing this service to some or all of their customers. While reporting of gross proceeds is relatively objective and straight-forward (brokers certainly *know* the proceeds of sell transactions that are processed through their firm), basis tracking by contrast involves many facts that are beyond the knowledge of brokers and will also present many unique challenges not typical of other reporting requirements.

Many of these challenges, such as the treatment of post year-end reclassifications and the proper adjustments to be made for issuer actions, cannot be solved by brokers working harder or devoting more resources to the task. Providing the industry with clear guidance on how to deal with these issues is crucial and must be accompanied by adequate time for firms to build and update the necessary systems to make basis reporting effective. With respect to the effective date, we have two specific recommendations:

(i) New requirements should extend to new assets only. We were pleased to see the Joint Committee limited its proposal to investments that are newly purchased at least eighteen months after the date of enactment. We see this prospective approach as the only feasible alternative, given brokers' imperfect ability today to determine basis and the wide variations among brokers in their current basis tracking practices.

(ii) IRS publication of rules and forms should precede enforcement. SIFMA believes the 18-month deadline contemplated in the Joint Committee report is insufficient and should be lengthened to reflect a reasonable period of time to come into compliance *after the publication of IRS specifications*. Any basis reporting regime will require the IRS to publish very detailed guidance and develop new reporting forms. Brokers will not be in the position to upgrade existing basis tracking systems or build new ones until such government specifications are in place. The amount of time that brokers would need to come into compliance following publication of guidance would depend upon whether basis reporting requirements are phased in as suggested above and, if so, what is encompassed in the first stage of requirements.

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Our member firms have had years of experience voluntarily undertaking to provide investors with basis tracking services, and this experience has shown

that basis reporting is far more difficult to accomplish than most reporting tasks previously delegated to our industry by Congress. We look forward to working with you to help achieve your tax administration goals in a way that substantially reduces the capital gains tax gap without imposing unnecessary costs on either the government or the private sector.

Thank you for your consideration of our views. We would appreciate the opportunity to discuss these issues with you or your staffs at your earliest convenience.

Sincerely,

Patti McClanahan
Vice President and Director for
Tax Policy

Jon Traub
Vice President for Federal
Tax Legislation