

REG-101896-09  
LEGAL PROCESSING DIVISION  
PUBLICATION & REGULATIONS  
BRANCH

FEB 12 2010

# PUBLIC SUBMISSION

<b>As of:</b> February 12, 2010
<b>Received:</b> February 05, 2010
<b>Status:</b> Posted
<b>Posted:</b> February 12, 2010
<b>Tracking No.</b> 80a8ed23
<b>Comments Due:</b> February 08, 2010
<b>Submission Type:</b> Web

**Docket:** IRS-2009-0037

Basis Reporting by Securities Brokers & Basis Determination for Stock

**Comment On:** IRS-2009-0037-0001

Basis Reporting by Securities Brokers and Basis Determination for Stock

**Document:** IRS-2009-0037-0009

Comment on FR Doc # E9-29855

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## General Comment

The comments are attached.

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## Attachments

**IRS-2009-0037-0009.1:** Comment on FR Doc # E9-29855

February 5, 2010

**BY ELECTRONIC SUBMISSION AND REGULAR MAIL**

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Re: Proposed Regulations for Basis Reporting by Securities Brokers and Basis  
Determination for Stock: REG-101896-09

Dear Mr. Mundaca, Mr. Wilkins, Mr. Odintz, Ms. Baker, Ms. Colson and Mr. Schaeffer:

We would like to thank the Department of Treasury ("*Treasury*") and the Internal Revenue Service ("*Service*") for the detailed and thoughtful work that was obviously put into the proposed regulations on basis reporting by securities brokers and basis determination for stock (the "*Proposed Regulations*") issued December 17, 2009. It appears clear from the Proposed

Regulations that the intent of the Treasury and the Service is that the Proposed Regulations promote compliance while allowing the securities markets to function in an orderly fashion.

The unit investment trust (“UIT”) industry is committed to continuing compliance with its reporting obligations. However, we are writing on behalf of First Trust Portfolios L.P. (“*First Trust*”) requesting that the Treasury and the Service clarify certain aspects of the Proposed Regulations as they apply to UITs.

We realize that the Treasury and the Service have many demands on their time, and we would like to extend our gratitude for providing us with the opportunity to comment on these complex issues. We would like the opportunity to present our perspective at the hearing on the Proposed Regulations, and we would also appreciate the opportunity to discuss these comments with representatives of the Service and Treasury at their convenience.

First Trust is a UIT sponsor located in Wheaton, Illinois. First Trust was first formed in 1991 and at that time became successor to the “First Trust” product line which was initially offered in 1974. First Trust employs over 300 people, primarily out of its Wheaton, Illinois, office. First Trust sponsored 440 of the UIT industry's newly offered grantor UITs in 2009, which is approximately 70% of the traditional UIT industry.<sup>1</sup> Over the previous five years, First Trust has had (i) average annual UIT primary sales of \$14.4 billion, (ii) average UIT year-end assets under management of \$18.5 billion and (iii) average active UITs at year-end of 1,143.

## **1. OVERALL GOAL.**

Our overall goal in these comments is to conform broker reporting in respect of UITs to broker reporting of mutual funds to the extent possible.

Conforming broker reporting in respect of UITs to broker reporting of mutual funds will reduce broker expense and confusion and increase investor compliance. The broker community has faced significant challenges in meeting the statutory deadlines for compliance. Reducing the variations in the information that is required to be produced is intended to assist the broker community in reducing its compliance burden and speed the process of the necessary programming.

Such conformance may also reduce the Service’s administrative burden resulting from erroneous computer generated noncompliance notices issued in respect of UITs that have complied with the regulations for “widely held fixed investment trusts” (“*WHFITs*”), as defined

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<sup>1</sup> This would exclude exchange traded funds, variable annuities and similar products structured as UITs.

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in Treas. Reg. § 1.671-5(b)(22), which require reporting of certain percentages in reporting of cost basis of sales rather than dollar amounts..

### **2. BACKGROUND.**

UITs are investment companies that are required to be registered under the Investment Company Act of 1940 (the "*1940 Act*"). The UITs offered by First Trust are relatively fixed portfolios of equity or debt securities that have maturities that range from approximately 13 months to 30 years. A vast majority of the UITs sponsored by First Trust are structured to constitute trusts within the meaning of Treas. Reg. § 301.7701-4(c) and are treated as grantor trusts under Subpart E of Subchapter J of the Internal Revenue Code of 1986, as amended (the "*Code*"). Such grantor trust UITs are WHFITs and, in respect of the trusts sponsored by First Trust, are non-mortgage widely held fixed investment trusts ("*NMWHFITs*") as defined in Treas. Reg. § 1.671-5(b)(12).

Alternatively, some UITs elect to be treated as regulated investment companies ("*RICs*") under Code § 851(a)(1)(A). Such RIC UITs are subject to the rules of Subchapter M of the Code, just as a mutual fund would be.

Pursuant to the 1940 Act, a UIT, whether treated as a grantor trust or a RIC for Federal income tax purposes, is an investment company that (i) is organized under a trust indenture, (ii) does not have a board of directors and (iii) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. First Trust serves as the promoter, sponsor, depositor, principal underwriter and supervisor of the UIT. As such, First Trust is generally responsible for organizing new UITs, depositing securities or contracts to establish new UITs, preparing registration statements and offering documents, underwriting units of UITs, supervising the portfolios of UITs, fulfilling the regulatory requirements imposed on UITs and supporting a secondary market for certain UITs.

### **3. DEFINITION OF A REGULATED INVESTMENT COMPANY.**

The Proposed Regulations provide that "regulated investment company" be defined pursuant to Treas. Reg. § 1.1012-1(e)(5). However, the Proposed Regulations omit a definition. The current Regulations provide the following definition of "regulated investment company" in Treas. Reg. § 1.1012-1(e)(5):

- (i) For purposes of this paragraph, a "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542) which meets the limitations of section 851(b) and §1.851-2, and which is registered at all times during the taxable year under the Investment Company Act

of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company, or as a unit investment trust.

(ii) Notwithstanding subdivision (i), this paragraph shall not apply in the case of a unit investment trust unless it is one—

(a) Substantially all of the assets of which consist (1) of securities issued by a single management company (as defined in such Act) and securities acquired pursuant to subdivision (b) of this subdivision (ii), or (2) securities issued by a single other corporation, and

(b) Which has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

Under the definition of “regulated investment company” in the current Regulations, the majority of UIT RICs are excluded from the definition by Treas. Reg. § 1.1012-1(e)(5)(ii). The result of this exclusion is that holders of most UIT RICs would not be eligible to use the average cost method under Treas. Reg. § 1.1012-1(e) and, thus, not be eligible to use the broker’s default method under Code § 6045(g)(2)(B)(i)(II). Similarly, the “Applicable Date” of most UIT RICs under Code § 6045(g)(3)(C) would be January 1, 2011, as compared to January 1, 2012, for mutual funds.

We respectfully suggest that Treas. Reg. § 1.1012-1(e)(5)(ii) adds unnecessary complexity to the compliance obligations of brokers handling both UIT RICs and mutual funds. The complexity is likely to create numerous unintended compliance errors, with an uncertain policy basis at the present time.

We, therefore, respectfully request that current Treas. Reg. § 1.1012-1(e)(5)(ii) be deleted. The exclusion of Treas. Reg. § 1.1012-1(e)(5)(ii) is very specific in nature. It first appeared in the Regulations in 1972, and, we believe, was intended to exclude a type of UIT that is no longer sold today. We do not believe that the deletion of Treas. Reg. § 1.1012-1(e)(5)(ii) would have a significant impact beyond the issues related to cost basis addressed in the Proposed Regulations.

The result of such a deletion should be that UIT RICs would be eligible for the average cost method, the broker’s default method and have a January 1, 2012, Applicable Date.

**4. APPLICATION OF PROPOSED REGULATIONS TO WHFITs.**

a. COORDINATION WITH THE WHFIT REGULATIONS.

Code § 6045(g)(3)(A) defines “covered security” in terms of certain specified securities. “Specified security” is defined in Code § 6045(g)(3)(B). Units in WHFITs are not included in the list of items in Code § 6045(g)(3)(B)(i), (ii) or (iii). For the sake of clarity, we respectfully request that units in WHFITs should be treated as covered securities where the underlying assets are covered securities.

The Proposed Regulations provide in Prop. Reg. § 1.6045-1(d)(9):

*(9) Coordination with reporting rules for widely held fixed investment trusts under §1.671-5.* The information required to be reported under section 6045(a) must be provided with respect to the sale of an interest in a widely held fixed investment trust (as defined under §1.671-5). To the extent that any additional information reporting is required under section 6045(g), those requirements are deemed to be met through compliance with the rules in §1.671-5.

The current WHFIT Regulations describe the information that must be provided on the appropriate Form 1099 in Treas. Reg. § 1.671-5(d)(2)(ii). Basis reporting is not specifically listed in Treas. Reg. § 1.671-5(d)(2)(ii). However, subparagraph (H) of Treas. Reg. § 1.671-5(d)(2)(ii) provides that the trustee or middleman must include any other information required by Form 1099. Thus, if the applicable Form 1099 requires basis reporting, the WHFIT Regulations would generally require that the Form 1099 filed with the Service include a basis number.

At the same time, Treas. Reg. § 1.671-5(f) describes the safe harbor reporting obligations of the trustee of a NMWHFIT meeting certain requirements. Most NMWHFITs currently brought to market are intended to meet the safe harbor reporting requirements of Treas. Reg. § 1.671-5(f).

Under Treas. Reg. § 1.671-5(f)(2), if the trustee reports under the safe harbor, the Form 1099 to be filed with the Service is prepared according to special rules. The special rules do not have the general requirement that any other information required by Form 1099 be provided.

In regard to sales of trust assets, the special rules do not provide for basis reporting; instead, the special rules require that the trustee must provide the ratio (expressed as a percentage) of the assets sold on the date to all assets held by the NMWHFIT.

In regard to redemptions of trust interests, the NMWHFIT safe harbor allows the trustee to provide either (i) a list of dates on which the amount of redemption proceeds paid for the

redemption of a trust interest was determined and the amount of redemption asset proceeds determined per trust interest on that date or (ii) the date of the redemption and the amount of redemption asset proceeds per trust interest determined on that date.<sup>2</sup>

Similarly, in regard to the sale of a trust interest under the safe harbor, the trustee must provide, for each day of the calendar year, the amount of cash held for distribution on that date.<sup>3</sup>

Thus, in regard to sales of trust assets, the redemption of trust interests, and the sale of trust interests, the reporting required by the trustee under the NMWHFIT safe harbor in the WHFIT Regulations does not directly correlate to the reporting required on Form 1099. Most specifically, the information provided under the safe harbor may be a fraction or a table rather than a specific number in a box for the basis on Form 1099.

The combination of the last sentence in Prop. Reg. § 1.6045-1(d)(9) (which provides that reporting requirements under Code § 6045(g) will be deemed to have been fulfilled by compliance with the WHFIT regulations) and Treas. Reg. § 1.671-5(d)(2)(ii)(H) (which requires that any other information required by Form 1099 must be provided) creates an ambiguity as to what the actual reporting requirement is if Form 1099 is modified to require additional information not currently required by the WHFIT regulations.

We respectfully suggest that this ambiguity be resolved by allowing brokers and other middlemen to combine the basis information they have through managing the investor's account with the information provided by the trustee in compliance with the WHFIT regulations to produce a dollar amount for the basis of investments in a WHFIT in situations where basis reporting would be required under Code § 6045(g).

We respectfully suggest that this approach may be clarified by moving the text of Prop. Reg. § 1.6045-1(d)(9) into a new subparagraph (i) and adding a new subparagraph (ii) that would read as follows:

(ii) In complying with §1.671-5, a broker must take into account all information reported to the broker under §1.671-5. The broker will have complied with §1.671-5 and section 6045(g) if the broker applies the information provided by the trustee under §1.671-5 to the adjusted basis of the taxpayer as determined under §1.6045-1(d)(6) to determine the appropriate dollar amount of basis to be reported on Form 1099.

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<sup>2</sup> Other simplified reporting is permitted in some circumstances.

<sup>3</sup> Other simplified reporting is permitted in some circumstances.

The intent of this paragraph is to allow the brokers to combine the information provided from the WHFIT trustee with the information that they already have to determine the appropriate basis reporting.

b. AVERAGE COST BASIS.

As mentioned above, the current Regulations allow the average cost method for mutual funds. We have recommended above that the average cost method be extended to UITs that are treated as RICs for Federal income tax purposes.

Like RICs generally, WHFITs are sold in fungible investment units that are generally registered securities. The Proposed Regulations implicitly recognize this in Prop. Reg. § 1.1012-1(e)(3), which treats securities issued by unit investment trusts (as defined in the 1940 Act) as shares of stock. Under this provision, the sale of shares in a UIT treated as a WHFIT would be treated as a sale of stock so long as the WHFIT was a unit investment trust (as defined in the 1940 Act).

From both the brokers' and the investors' perspective, the Federal tax characterization of the UIT may have little impact on the manner in which the trust interests are sold or the decision to make an investment. To the extent possible, therefore, we believe that to avoid investor confusion and increase investor compliance, differences in the reporting provided to investors should be reduced or eliminated.

For this reason, we respectfully request that Prop. Reg. § 1.1012-1(e)(3) be amended to read as follows:

(3) *Shares of stock.* For purposes of this paragraph (e), securities issued by unit investment trusts (as defined in the Investment Company Act of 1940, as amended) are treated as shares of stock in a regulated investment company as defined in paragraph (e)(5) and the term *share* or *shares* includes fractions of shares.

The intent of this change is to allow UITs treated as WHFITs to use the average basis method and brokers to use such method in respect of interests in WHFITs.

**5. GRANDFATHERING AND APPLICABLE DATES.**

a. GRANDFATHERING.

In respect of certain trusts that qualify for the qualified NMWHFIT exception under Treas. Reg. § 1.671-5(c)(2)(iv)(E), the information required to be provided to a broker or investor under the WHFIT rules does not include information in regard to basis. This is in part

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because such trusts were formed before the WHFIT rules became effective and the trustee did not gather the information relating to the bases of the trust interest holders.

The wording suggested above for new subparagraph (ii) to Prop. Reg. § 1.6045-1(d)(9) is intended to allow brokers to rely only on their own basis information if none of the information provided by the trustee to the broker relates to basis or may reasonably be interpreted to determine the portion of the basis attributable to the trust interest sold.

If a more explicit provision is necessary to make it clear that trustees are not required to provide information to brokers not currently required under the WHFIT rules, we respectfully suggest that one be added.

b. APPLICABLE DATES.

Under Code § 6045(g)(3)(C), without the changes recommended in this letter, the requirements of Code § 6045(g) would appear to apply to UITs that are treated as RICs on January 1, 2011; mutual funds on January 1, 2012; and UITs that are WHFITs on January 1, 2013 (if at all).

It is the intent of the changes recommended in this letter for UITs that are treated as RICs and UITs that are WHFITs to qualify for the January 1, 2012 applicable date, consistent with mutual funds.

Again, we appreciate greatly the time and effort that has obviously gone into the Proposed Regulations. We are committed to working with the Treasury and the Service to maintain the industry's compliance and to ease the compliance burden on brokers and investors. We look forward to an opportunity to speak with you in person, either in the hearing or separately, in regard to these matters.

Please contact Paul Carman at (312) 845-3443 with any questions or comments.

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Very truly yours,

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By

Paul D. Carman