



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

January 9, 2009

Eric A. San Juan
Acting Tax Legislative Counsel
Office of Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Dear Mr. San Juan:

Re: Securities Basis Reporting by Qualified Intermediaries (QIs)

I thank you and your colleagues for taking the time to speak with me and members of our Association's Qualified Intermediary Committee on October 8, 2008. During that conference call, we were asked to draft a letter outlining our interpretation of the amendments to Internal Revenue Code (the "**Code**"), Section 6045, and how these amendments would adversely impact QIs. In addition, we were asked to locate the source of the authority for the Treasury Department to draft regulations to accompany the amendments that would effectively exclude QIs from the new reporting requirements, and to suggest draft language that might be included in such regulations.

The Investment Industry Association of Canada (**IIAC**) is Canada's equivalent to the Securities Industry and Financial Markets Association (**SIFMA**) in the United States. All but a few of Canada's over 200 investment broker-dealers are members of the IIAC. The IIAC QI Committee is responsible for reviewing and commenting on amendments to legislation that would affect the Canadian QI community, and developing positions on practical and conceptual matters surrounding U.S. tax reporting requirements, including audits and QI forms.

Background on Qualified Intermediaries

Revenue Procedure 2000-12, The Qualified Intermediary Agreement (the "**QI Agreement**") has been in effect since January 1, 2001. All foreign intermediaries entering into the QI Agreement are "Qualified Intermediaries" (**QIs**). A QI is a withholding agent under Chapter 3 of the Code, and a payor under Chapter 61 and Section 3406 of the Code for amounts that it distributes to its account holders. Except as otherwise provided in the QI Agreement, a QI's obligations with respect to distributions to account holders are governed by Chapters 3 and 61 and Section 3406 of the Code and its related regulations. There are approximately 6,500 QIs worldwide.

Amendments to Internal Revenue Code, Section 6045

The basis reporting amendments to Section 6045 of the Code were passed as section 403 of Division B of H.R. 1424, the *Energy Improvement and Extension Act of 2008* (the “**Amendments**”). The Amendments require the reporting of a U.S. client’s adjusted cost basis in a covered security¹ as part of Form 1099-B, as well as identification of whether a gain or loss with respect to the security is long- or short-term. These reporting requirements will apply to securities acquired on or after the effective date or transferred into the account on or after the effective date if basis information was provided by the transferor. The effective date is January 1, 2011 for stock in a corporation, January 1, 2012 for stock in open-end mutual funds and dividend reinvestment plans, and January 1, 2013 for other securities.

Challenges Faced by Canadian QIs Relating to the Amendments

Given the proximity of Canada to the U.S., and the mobility of individuals back and forth across the border, one would assume that the Canadian QI community is likely to have a greater number of accountholders for whom the reporting of proceeds on Form 1099-B is required, than do QIs in other jurisdictions. However, our initial analysis clearly indicates that Canadian QIs do not have a significant number of such accountholders. Our analysis, based on estimates compiled from a sample of our largest member firms, found that the number of accountholders for whom reporting of proceeds is required is significantly less than 1% of their total number of accounts that are subject to their QI Agreements.

Given the small number of accountholders for whom basis reporting will likely be required, it is unlikely that QIs will be able to justify making the complex and very costly system changes that would be required to fully automate the calculation and maintenance of cost-basis information for the purposes of satisfying the reporting requirements of the Amendments. As a result, alternative solutions that require greater reliance on manual procedures will likely be necessary, still with a very significant cost to the QIs that will almost certainly have no ability to recover related costs from the client.

No or Limited Basis Calculations Currently Performed

Many QIs do not currently have systems that maintain basis information or they provide such information as a client service only, qualifying the accuracy of the information being provided. The reliability of the information is frequently limited by many factors that lie outside of the control of the brokers, including the accuracy of information that is provided by previous brokers for assets transferred to the client’s account. Significant enhancements to systems and procedural changes would be required to refine the accuracy of the information provided. Given the small estimated number of clients for

¹ “Covered Security” includes any stock, note, bond, debenture or other evidence of indebtedness, commodity, contract or derivative with respect to the commodity, or any other financial instrument that is determined to be appropriate by the Secretary.

whom such reporting would be required, the QI may need to rely on manual processes and procedures.

Multiple Basis Calculation Methods

Canadian QIs that are providing cost basis information for Canadian securities use the weighted average cost method as required for Canadian income tax purposes (other calculation methods may be used by QIs in other jurisdictions). For this reason, Canadian QIs would need to maintain at least two types of tracking systems. In addition to the calculation of cost being different for Canadian and U.S. reporting purposes, the U.S. calculations are further complicated by rules that apply different methods to different types of assets, and also allow individual taxpayers to make their own elections as to the method of calculation to be used. The requirement to separately report short- and long-term capital gains (based on U.S. tax requirements) would add an additional element of cost and complexity.

Foreign Currency Exchange

The calculations are further complicated by foreign currency exchange. For many account holders with accounts outside the U.S., the base currency of the account will not be in U.S. dollars. Additional currency conversion information will be needed if cost basis must be determined in U.S. dollars based on the exchange rate in effect at the time of the transaction, which could vary significantly between brokers based on the source of their rate information.

Determination of U.S. Tax Implications of Corporate Actions

Corporate actions are currently processed in accordance with tax laws or standard industry practices applicable in the QI's jurisdiction. There will be a significant cost associated with determining the U.S. tax implications of the event on the cost of a U.S. taxpayer's holdings, as well as posting the event differently for U.S. tax purposes. This is further complicated by the fact that a large portion of the securities held by QIs are non-U.S. and information regarding the U.S. implications of an event may not be readily available.

Basis Calculations Impacted by Non-Cash Amounts

The cost of certain types of investments is not necessarily based on cash payments. For example, the cost of a partnership interest is based on the investor's share of the partnership's income or loss, as well as contributions to and withdrawals from the partnership. For other investments, distributions may automatically be reinvested without the payment of cash. Custodians do not have the information required to maintain cost basis information in these situations.

Existing Accountholders that Become U.S. Persons

Given initial findings that suggest that basis reporting might be required for less than 1% of a QI's client base, it is unlikely that the calculation process and data retention can be automated. Based on this premise, it would only be practical for a QI to maintain such information for those clients that become U.S. persons for securities acquired or transferred after the date that the QI is aware of the change in status, unless cost at the time of becoming a U.S. person can be used in all such situations.

Filing Deadline

Although the Amendments extend the Form 1099 filing deadline from January 31 to February 15, the timelines remain extremely tight for QIs, especially in the following instances:

- Where there has been a corporate action for which the issuer is required to provide additional information;
- Where there has been a transfer of securities late in the year for which the transferor must provide cost basis information by January 15, following the year-end;
- For holdings such as certain Canadian mutual funds, for which a portion of distributions may be a return of capital, impacting cost basis, but for which the information is not often available prior to February 15, or later;
- For reinvestment amounts for the many investments with automatic dividend reinvestment plans for which the amounts are often not identified until after year-end.

Transfer of Basis Information Between Brokers

Based on earlier discussions related to the small percentage of account holders for whom reporting would be required, if QIs are dependent on manual procedures to calculate, track and report U.S. cost basis, it will be very difficult to develop a standard method for efficiently transferring cost information within 15 days of the transfer when shares are transferred from one broker to another or from one QI to another.

Reconciling Differences with Accountholders

Despite best efforts on the part of the QI to provide accurate cost basis information, it is inevitable that there will be discrepancies between the amounts determined by the QI and the amounts determined by its account holders. Considerable resources will be consumed addressing these differences with account holders, and most likely at a time when these resources are otherwise engaged in year-end reporting activities. In addition to the heavy demand on resources, despite all efforts by the QI, these differences are often likely to result in friction and unnecessary client dissatisfaction with no easy solution.

Procedures Under Section 3.05 of the QI Agreement

Under Section 3.05 of the QI Agreement, a QI that has not assumed backup withholding and Form 1099 reporting responsibilities can request another payor to report and, if required, backup-withhold on broker proceeds. Other payors that have agreed to take on this reporting and withholding responsibility may not have the ability to provide cost basis reporting, depending on the structure of the QI's accounts with the payor.

Relief from Reporting Penalties

Although information contained in the Administration's Fiscal Year 2009 Revenue Proposals indicates that, under regulations, a broker would not be penalized for failure to accurately report items of information that the broker is unable to obtain with "reasonable efforts", it is not clear what will be considered to be a reasonable effort in any particular instance. While administrative relief is welcome, we believe that the term "reasonable efforts" should be clearly defined under the regulations. We also recommend that there should be transitional relief from reporting penalties for two years after the reporting requirements take effect.

The Authority for Treasury to Draft Regulatory "Carve-Out" Provisions for QIs

Paragraph 6045(a) of the Code provides a broad authority for Treasury to draft regulations and forms with respect to the reporting requirements of Section 6045:

Every person doing business as a broker shall, **when required by the Secretary, make a return, in accordance with such regulations as the Secretary may prescribe**, showing the name and address of each customer, with such details regarding gross proceeds, and such other information **as the Secretary may by forms or regulations require** with respect to such business. **(emphasis added)**

We understand that Treasury must draft regulations that reflect the purpose and intent of legislation, and it is our position that drafting regulations that exclude QIs from the cost basis reporting requirements would not be a derogation from the intent of the Amendments. The legislation was adopted to improve compliance related to the reporting of capital gains and losses realized on dispositions of securities by U.S. individual taxpayers, the bulk of which will be captured by the reporting submitted by U.S. brokers. This legislation potentially extends the application of cost basis reporting to QIs, which would seem to go beyond the intent of the legislator, and should be excluded by regulations because of the unduly burdensome nature of the requirements, particularly in relation to the nominal contribution that will be made to increasing compliance by U.S. individuals.

GAO-06-603 recommended that cost basis reporting be implemented to reduce the capital gains tax gap, but recognized that cost basis reporting would "raise challenges that would need to be addressed...brokers would incur costs and burdens...and many issues would arise about...which securities would be covered." This suggests that when the

GAO made its recommendations regarding legislation, flexibility was contemplated in how the basis reporting requirements should be applied, and recognized that these requirements might not be appropriate for some types of securities, or, as we would argue, for some types of filers of Forms 1099-B.

In April 2007, Eric Solomon, the Assistant Secretary for Tax Policy testified before the Senate Finance Committee, stating that “the Administration is committed to reducing the tax gap without unduly burdening honest taxpayers who currently meet their tax obligations.” We contend that imposing the cost basis reporting requirements on QIs would be unduly burdensome by forcing the QIs to incur high costs of compliance, which are unlikely to be recouped from clients. Furthermore, based on our initial estimates that basis reporting would be applicable to a very small number of accountholders, this would likely result in little or no change to the U.S. tax gap. This is precisely the type of situation that warrants the drafting of a regulation to create an exemption for QIs.

Proposed Regulations

It is difficult for us to suggest draft language to implement such an exemption without first reviewing any proposed regulations that Treasury is drafting with respect to the Amendments. We would be pleased to review any draft regulatory language once it has been prepared, to ascertain how best to insert relief that would carefully exclude QIs from the cost basis reporting requirements and not create loopholes that could be inappropriately exploited by others, undermining the purpose of the Amendments.

Request for further discussions

The staff of the IIAC and the members of our QI Committee would very much appreciate the opportunity to discuss our issues with the Treasury Department, and answer questions or assist with the development of draft regulations excluding QIs from the requirements contained in the Amendments. During the conference call on October 8, 2008, it was mentioned that there may be hearings on this matter, and we would appreciate receiving any information available on where and when we might be able to present our information and arguments to ensure that those who are drafting the regulations understand the reasons for, and the importance of, our request.

Yours truly,



Jack Rando
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