



Wolters Kluwer Financial Services Tax Alert

The New Cost Basis Reporting Law: An Overview

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On October 3, 2008, the required reporting of cost basis by brokers to the IRS and taxpayers became law. It was included as Section 403 of H.R. 1424, the Emergency Economic Stabilization Act of 2008, that was enacted in response to the financial market crisis (the "Act," Pub. L. No. 110-343).¹ One principal goal of cost basis reporting is to prevent investors from underreporting gains and overreporting losses on stocks and securities on their tax returns. The Joint Committee on Taxation estimates that the law will raise \$6.67 billion in tax revenue over a 10 year period. Another goal is the promotion of tax simplification for individual investors. However, the tax rules for computing the adjusted basis and gains and losses on securities are not made simpler by the new law. Instead, these goals are essentially achieved by placing the burdens of computing adjusted basis and reporting on brokers and custodians.

This is an overview of key details of the new cost basis reporting law. It is not intended to be comprehensive. Brokers, custodians and others should and will consult their own advisors for guidance on cost basis reporting. There will be questions and concerns regarding the proper treatment of specific securities, raised by various tax rules, and under particular facts that are beyond the scope of this overview. Moreover, the only guidance presently available is the text of the new law and Congressional committee staff prepared explanations. Brokers and custodians will be looking to the Internal Revenue Service (IRS) to issue guidance such as regulations to address important details and specific concerns raised by cost basis reporting. Readers should stay alert and must independently monitor developments in this area. For example, future IRS guidance could resolve concerns or raise new issues or problems for brokers in preparing for required reporting of cost basis.

A copy of the relevant excerpt of the enrolled text of the new cost basis reporting law that was included in the Act is available in the section titled "Cost Basis Reporting is Now Law" on the home page at www.costbasisreporting.com.

EXECUTIVE SUMMARY:

EFFECTIVE DATES

The law includes a three stage phase-in, with a first effective date of January 1, 2011.

REQUIRED REPORTING INFORMATION

The law requires brokers to report adjusted basis and whether a gain/loss is short-term/long-term.

PENALTIES FOR INCORRECT REPORTING

There are significant tax penalty risks for non-compliance.

CORPORATE ACTIONS

With the new law, basis must be adjusted for corporate actions.

WASH SALES

Additionally, adjusted basis must take into account loss deferrals and related adjustments for wash sales.

CUSTOMER SELECTION OF LOT RELIEF METHOD

The law requires brokers to offer a range of lot relief selection methods including "highest-in, first-out," "last-in, first-out," and various other methods.

AVERAGING COST BASIS FOR MUTUAL FUND & DRIP SHARES

Averaging DRIP share basis applies to both the original DRIP shares purchased and the subsequent shares acquired due to dividend reinvestment.

¹ Act Section 403. A copy of the actual text of the new cost basis reporting law excerpted from the Act is available at www.costbasisreporting.com/pdf/TITLEIVSEC403.doc.

EXECUTIVE SUMMARY (continued):

SHORT SALES

With the law, short sales are subject to cost basis reporting based on whether the security used to close the short sale is a covered security.

OPTIONS

Options are subject to cost basis reporting under the new law.

BROKER BASIS REPORTING ON CUSTOMER ACCOUNT TRANSFERS

The law obligates a transferring broker to furnish a receiving broker with information necessary for cost basis reporting within 15 days of the transfer.

CORPORATE ACTION REPORTING BY ISSUERS OF SECURITIES

Issuers of specified securities are also subject to new tax return obligations under the cost basis reporting law in connection with corporate actions.

DATE FOR FURNISHING CUSTOMER STATEMENT EXTENDED

The cost basis reporting law amends the due date for furnishing customers with their copies of Form 1099-B from January 31st to February 15th.

EFFECTIVE DATES

The law provides for a three stage phase-in of cost basis reporting based on the type of security and when it is acquired:

Stock acquired on or after January 1, 2011;

Mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012; and

Other specified securities (principally debt securities and options) acquired on or after January 1, 2013.²

Thus, brokers have only slightly more than two years to prepare for the initial phase of cost basis reporting generally applicable to stock. Given the complexities of computing adjusted cost basis and brokers' software and accounting systems, meeting the looming deadline could be a significant challenge. Some have said that there is actually over three years to prepare because the deadline for providing and filing information returns with cost basis information will not occur until February 2012. However, a potential fatal flaw with this reasoning is that the broker's data system must capture adequate basis information for any stock acquired on any date during calendar 2011. If the system does not, it could be impossible to compute the adjusted basis needed for the information returns due in 2012. Another concern is that customers need to be provided with the ability to use all required lot relief methods as of the January 1, 2011 effective date.

The reason for the staggered effective dates is that it was believed that computing adjusted basis for mutual fund and DRIP shares, as well as other securities subject to cost basis reporting such as debt securities and options would be more complex, thus requiring more time for brokers to prepare for basis reporting for such shares and securities. Due to recurring dividend reinvestment in new shares and other issues such as

² In order for a security to be subject to cost basis reporting it must be a "specified security" that is also a "covered security." Internal Revenue Code (Code) Section 6045(g)(3)(B) defines specified security to include any stock in a corporation (note that real estate investment trusts are treated as corporations for U.S. federal income tax purposes); any note, bond, debenture, or other evidence of indebtedness; any commodity, contract or derivative with respect to a commodity (if the IRS so chooses); and any other financial instrument (if the IRS so chooses). Code Section 6045(g)(3)(A) essentially defines a "covered security" as a specified security acquired on or after the applicable effective date but provides an exception for pre-effective date securities that are transferred to another account or broker. Code Section 6045(h) provides for reporting relating to options.

commission charges or loads, mutual fund and DRIP share basis tracking can be extremely detailed and beyond the capability of many existing systems. Moreover, the tax rules for debt securities are very complicated and developing basis tracking systems for options is uncharted territory because options are not currently subject to Form 1099 tax reporting. Thus the additional work for reporting the securities covered in the later effective date phases means that brokers will be challenged to meet the effective date deadlines for such securities.

Grandfathering and sorting could also raise system challenges. Because cost basis reporting only applies to securities acquired on or after the applicable effective date, brokers must sort and separate such post-effective date acquired securities from the pre-effective date securities. As customers sell their positions, brokers must have the ability to identify whether pre-effective date or post-effective date securities were sold in order to determine whether cost basis reporting is required. The software and accounting system mechanics of such an exercise could be difficult. Similarly, because of the three phases of effective dates, brokers systems must correctly sort securities into the various categories in order to apply the proper basis rules to each and to correctly determine whether a security is a pre-effective or post-effective date acquisition. For example, a share of stock acquired on January 15, 2011 would be subject to cost basis reporting (it would be a post-effective date acquisition under the phase 1 effective date) unless it is DRIP stock. If it is DRIP stock, it would be a pre-effective date acquisition and would not be subject to cost basis reporting.

REQUIRED REPORTING INFORMATION

Cost basis reporting requires brokers to provide additional information on an existing type of information return (Form 1099-B) for gross proceeds reporting on sales of securities that they currently provide to the IRS and to customers. The key provisions of the cost basis reporting law amend and add new sections to Internal Revenue Code (Code) Section 6045 that requires broker gross proceeds reporting. New Code Section 6045(g)(2)(A) requires brokers to include "the customer's adjusted basis in such security and whether any gain or loss with respect to such security is long-term or short-term..." Thus, Form 1099-B will need to be modified to include this additional information (adjusted basis and whether gain/loss is short-term/long-term).

PENALTIES FOR INCORRECT REPORTING

Failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to significant tax penalty risk. The penalty for an error is essentially \$100 per incorrect Form 1099 (a \$50 penalty for providing the IRS an incorrect Form 1099 and another \$50 penalty for providing the taxpayer with an incorrect Form 1099), subject to a current maximum on the broker for all failures during the calendar year of \$350,000 (\$250,000 on the returns provided to the IRS and \$100,000 on the returns provided to taxpayers). In the case of an error that is due to intentional disregard, the aggregate penalty is the greater of \$200 or 10% of the amount required to be reported correctly per return, without any maximum limitation.

CORPORATE ACTIONS

In order for a broker to compute the customer's adjusted basis, the broker must consider all of the applicable tax rules. A customer's initial basis in his or her security is cost, adjusted for commissions paid. The most common adjustments to a customer's basis in his or her security relate to corporate actions by the issuer of the security that affect the investor's security, such as stock split or dividend, a merger or spin-off, a return of capital or even a mere change of the issuing corporation's name or the security's identification number (CUSIP). Brokers will need to correctly adjust a customer's basis in a security for these various actions to comply with cost basis reporting. The cost basis reporting law also created new Code Section 6045B that requires issuers of securities to provide customers or their nominees with a statement that includes tax information detailing the effect of a corporate action on the investor's basis in his or her security.

However, the cost basis reporting law does not provide many details of this new corporate action statement requirement and brokers will bear the burden of processing such statements.

WASH SALES

The cost basis reporting law specifically requires brokers to report adjusted basis on Form 1099-B in a manner that takes into account loss deferrals and related adjustments for wash sales under Code Section 1091 but only wash sales computed using two key simplifying assumptions (Code Section 6045(g)(2)(B)(ii)). First, only securities within a single account (rather than all of the accounts of a taxpayer) are analyzed for purposes of determining whether a wash sale has occurred. Second, only identical securities (based on identical CUSIPs) are subject to wash sale deferral rather than all "substantially identical securities" (as is the case generally under the wash sale rule). It should be noted that these simplifications only apply for purposes of broker computations of adjusted basis for cost basis reporting. Taxpayers must still apply the regular wash sale rule in preparing their tax returns.

Adjusting the basis of securities to account for wash sales can be complex. The rule results in the deferral of losses on the securities sold when a wash sale is triggered. It also results in an adjustment later when the newly acquired securities that triggered the wash sale are subsequently disposed. In addition, the wash sale rule also results in adjustments to the holding period of the subsequently disposed securities. Because securities are routinely bought and sold in different quantities, the wash sale rule includes special provisions that address how to apply the rule when the quantity sold is different from the quantity of the newly acquired securities that triggered the wash sale. The application of these special provisions to the tax lots of securities held by an investor can be complex and have a profound effect on the computation of adjusted basis and holding period.

CUSTOMER SELECTION OF LOT RELIEF METHOD

To compute the adjusted basis of securities sold, the proper lot (or lots) of securities held by the customer must be determined. This process is often referred to as "lot relief." The cost basis reporting law generally provides that adjusted basis is determined "in accordance with the first-in first-out method unless the customer notifies the broker by means of making an adequate identification of the stock sold or transferred..." (Code Section 6045(g)(2)(B)(i)(I)). Adequate identification (often referred to as "specific ID") encompasses a range of lot relief selection methods including "highest-in, first-out," "last-in, first-out," and various other methods, some of which are proprietary to certain brokers or investment managers. It is important to note that other than in the case of mutual fund and DRIP shares, the tax law does not permit the use of average basis for adjusted basis determinations for securities. The cost basis reporting law also provides that the lot relief methods are applied on an account by account basis (Code Section 1012(c)(1)).

Note that the law creates both a default rule and an exception. The first-in, first-out (FIFO) method is the default. The other methods (all derived from the adequate identification method reference) are available only if the customer notifies the broker that he or she wants to use a method besides FIFO. Thus, brokers will generally need to provide for FIFO default, respond to customer notifications, and provide lot relief based on the method selected by the customer. As a result, brokers' systems will need to support multiple lot relief methods.

In the case of mutual fund and DRIP shares, the law provides that the broker selects the default method of lot relief (which could be a permitted average basis method rather than FIFO, for example) "...unless the customer notifies the broker that he elects another acceptable method..." (Code Section 6045(g)(2)(B)(i)(II)). Because the customer can elect another method, brokers systems for mutual fund and DRIP shares will also generally need to support multiple lot relief methods.

AVERAGING COST BASIS FOR MUTUAL FUND & DRIP SHARES

Existing IRS regulations issued under Code Section 1012 relating to basis permit the averaging of certain mutual fund and unit investment trust shares.³ Because the cost basis reporting law generally only applies to securities acquired on or after a specified date (January 1, 2012 in the case of mutual fund and DRIP shares), as discussed above a broker would generally need to sub-divide a customer's account holdings into pre-effective and post-effective date acquired shares. Such account bifurcation could be burdensome for some brokers or accounting systems given the high number of tax lots created due to the reinvestment of dividends in new shares of stock. Thus, the cost basis reporting law amends Code Section 1012 to permit a fund to elect to combine the post-effective date holdings of such stock with pre-effective date holdings (Code Sections 1012(c)(2)(B) and 1012(d)(3)).

As indicated above, existing IRS regulations only permit basis averaging for certain eligible mutual fund shares. New Code Section 1012(d) permits averaging basis for DRIP shares. Averaging applies to both the original DRIP shares purchased and the subsequent shares acquired due to dividend reinvestment (Code Sec. 1012(d)(4)(B)).

SHORT SALES

Short sales are subject to cost basis reporting based on whether the security used to close the short sale is a covered security. Brokers currently report gross proceeds from short sales on Form 1099-B in the year the short sale is entered into, rather than the year the short sale is closed. Unfortunately, such tax reporting is inconsistent with the normal tax treatment of short sales. Under current tax law (provided that a short sale does not trigger a constructive sale under Code Sec. 1259), a short sale is typically taxed in the year the short sale is closed. The cost basis reporting rules add new Code Section 6045(g)(5) that requires reporting of short sales in the year they are closed rather than the year they are opened or entered into.

Because short sales are subject to reporting based on the related security and given the inclusion of Code Section 6045(g)(5), brokers must correctly report adjusted basis and whether gain or loss is long-term or short-term for short sales. Brokers will need to consider the special provisions of the wash sale rules of Code Section 1091 relating to short sales and the special holding period rules of Code Section 1223 for short sales in order to correctly report such information. The effective date of short sale cost basis reporting appears linked to the applicable effective date for the related security used to close the short sale.

OPTIONS

It is significant that options are subject to cost basis reporting under the new law. Presently, options are not subject to Form 1099-B information reporting. Brokers will need to develop new systems to address options reporting. New Code Section 6045(h) sets forth the specifics for options reporting. Both the exercise of an option, as well as the lapse or closing of an option transaction must be taken into account in cost basis reporting. If options are exercised and related covered securities are acquired or sold, the amounts paid or received for the options must be taken into account in computing the gross proceeds or adjustments to basis that result (Code Section 6045(h)(1)). If options lapse or are disposed of in a closing transaction, cost basis reporting also applies (Code Section 6045(h)(2)). Cost basis reporting for options on covered securities applies for both physically settled options (where the related security is delivered) and cash-settled options (Code Section 6045(h)(2)). The tax law including applicable IRS regulations provides some specific rules relating to the taxation of options and basis. Brokers will need to consider these rules and options data in developing systems to address the new option cost basis reporting requirement.

³ Treas. Reg. Sec. 1.1012-1(e).

BROKER BASIS REPORTING ON CUSTOMER ACCOUNT TRANSFERS

A particular concern under cost basis reporting relates to transfers of customer accounts from one broker to another. Unless the receiving broker is provided with the necessary information, such broker will likely not have the information necessary to comply with the new law when the customer subsequently disposes of transferred securities. The cost basis reporting law includes new Code Section 6045A that obligates a transferring broker (or other persons as provided in IRS regulations) to furnish the receiving broker with information necessary for cost basis reporting. The details of the information to be provided will be specified in future IRS regulation. The statement must be provided no later than 15 days after the date of the transfer (Code Section 6045A(c)). Brokers will be subject to potential IRS penalties relating to incorrect or late statements. These new broker transfer statement requirements are essentially effective as of the respective phased-in effective dates for cost basis reporting set forth above (see reference to covered security in Code Section 6045A(a)).

Brokers will need to develop systems to timely generate the statements required to meet their obligation when a customer transfers his or her account to another broker. Thus, a broker's cost basis information must be readily accessible throughout the year in order to permit the broker to comply with this statement requirement. For brokers of almost any size, their systems should probably accommodate daily account transfers. Brokers will also need to develop systems to process the information received when a customer transfers his or her account to them.

CORPORATE ACTION REPORTING BY ISSUERS OF SECURITIES

Issuers of specified securities are also subject to new tax return obligations under the cost basis reporting law in connection with corporate actions. New Code Section 6045B obligates the issuer of any specified security to make a return describing the corporate action and "the quantitative effect on the basis of such security resulting from such action..." and file the return with the IRS and furnish statements to holders or nominees (Code Section 6045B(a)(2) and (c)). The return must be filed no later than 45 days after the date of the corporate action or January 15th of the following year (if earlier)(Code Section 6045B(b)). The IRS could waive the filing and statement requirements if the information required is made publicly available in a manner yet to be determined by the IRS (Code Section 6045B(e)). Brokers could be liable for tax penalties for the failure to timely file or provide holders with the required statements and for incorrect information. These new broker transfer statement requirements are essentially effective as of the respective phased-in effective dates for cost basis reporting set forth above (Code Section 6045B(d)).

Corporate issuers and brokers have very little time to prepare to issue such statements and develop systems to process them.

DATE FOR FURNISHING CUSTOMER STATEMENT EXTENDED

Currently, the due date for furnishing customers with their copy of Form 1099-B is January 31st of the following year. The cost basis reporting law amends Code Section 6045 to change this deadline from January 31st to February 15th. A later due date had been requested by the industry and this change should be well received. Consolidated reporting statements (providing customers with information that would ordinarily appear on other types of information returns) are also eligible for the new February 15th deadline (see new sentence at the end of Code Section 6045(b)). The definition of a "consolidated reporting statement" will be defined in forthcoming IRS regulations. This change is effective for information returns filed in 2009. Brokers and their advisors are likely to scrutinize the relevant details regarding the applicability of the consolidated statement provision.

CONCLUSION

This overview summarizes the key details of the new cost basis reporting law. As IRS guidance is developed, other issues are likely to emerge. Moreover, there are a number of special tax rules that affect computations of adjusted basis that are not explicitly addressed in the cost basis reporting law. Brokers have significant challenges in preparing for the deadlines looming ahead.

October 24, 2008

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