The New Cost Basis Reporting Law and Concerns for Transfer Agents

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Buried in the nooks and crannies of the $700 billion bailout bill signed into law on October 3, 2008 (the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343), was a tax provision that requires brokers to report the cost basis of stocks and securities sold to the IRS and customers, beginning with stocks acquired on January 1, 2011. Many transfer agents could become ensnared in the complexities of cost basis reporting as discussed below. There are several potential concerns.

Broker cost basis reporting was enacted to reduce the so-called tax gap by making sure that investors accurately report gains and losses from securities transactions. It also promotes tax simplicity for individuals by shifting the basis calculation burdens to brokers. The reason it was included in the bailout bill and enacted is that it was scored as raising $6.67 billion in tax revenues over a10-year period.

Currently, brokers report the gross proceeds of securities sales to the Internal Revenue Service (IRS) and customers on Form 1099-B. Under the new law, brokers will be required to additionally report on Form 1099-B the adjusted cost basis and whether any gain or loss is long-term or short-term of a "covered security."

The tax law defines a "broker" obligated to provide Form 1099-B broadly. The existing regulations include as examples, mutual funds, custodians, escrow agents and stock transfer agents. Although there are some technical issues regarding whether some persons considered brokers currently will still be treated as brokers under the new law, as a rule of thumb, a broker subject to the new cost basis reporting law should generally be someone who has an existing Form 1099-B reporting obligation.

One important aspect of the new law is that it includes a later effective date (stock acquired on or after January 1, 2012 rather than 2011) and permits basis averaging for dividend reinvestment plan (DRIP) stock (and mutual fund shares). Debt and options acquired on or after January 1, 2013 are also subject to basis reporting.

Generally, basis averaging is not permitted for non-DRIP or mutual fund stock under the tax law. Instead, brokers must track the basis and holding period of each tax lot purchased by a customer and use the first-in, first-out (FIFO) method for determining the basis of the lots sold, unless the customer instructs the broker to treat lots sold under one or more specific identification (Specific ID) methods.

Allowing brokers to compute basis using one of two IRS regulation permitted averaging methods simplifies brokers' work in matching the proper basis and holding period information with each sale. Unfortunately, the new law permits customers to elect out of the method selected by the broker and require broker basis reporting using another customer selected method, such as FIFO or Specific ID. The customer's ability to elect out means brokers' systems will need to handle multiple methods for computing basis.

Another big concern is determining when stock is treated as DRIP stock eligible for the later effective date and averaging. For example, is DRIP status dependent on whether a customer has made a DRIP election? If so, brokers could be required to apply different basis reporting effective dates and basis method depending on the customer's election. Also, brokers and transfer agents will ask if stocks under other types of purchase plans besides dividend reinvestment are considered DRIP shares in order to determine if they are eligible for the later effective date and averaging. For example, can non-dividend paying stock qualify as DRIP? And, what happens to stock acquired before a DRIP plan begins or after it ends?

Sorting stock into DRIP (and mutual fund) and non-DRIP categories and determining the basis of the particular shares deemed sold is only part of the problem. The basis of stock often changes from the amount paid at the time of purchase for a variety of reasons. Corporate actions and wash sales are two of the most significant reasons calculations of adjusted basis can become very complex, requiring dedicated resources and processing power. Brokers will be required to make both of these adjustments under the new law and there are concerns that many existing data systems do not correctly track these adjustments.

The new law requires corporate issuers of covered securities to report in a written statement the "quantitative effect" of corporate actions on the basis of affected securities to both the IRS and nominees of holders. This statement is intended to relieve some pressure on brokers regarding corporate action adjustments, but it may not do the trick. The statement must be provided to the IRS no later than the earlier of 45 days after the date of the action, or January 15 of the following calendar year. It must be provided to holders (or nominees) by January 15 of the following calendar year. The IRS can, by regulation, permit issuers to make the information publicly available in lieu of the return filings. This presents three big concerns. First, the January 15 deadline for corporate action reporting to holders or nominees could pose a challenge. Because brokers typically adjust positions for corporate actions daily, the later receipt of an issuer corporate action statement will likely require reconciliation and possible adjustment. The second concern is getting the information to brokers because the statements are delivered to holders (or their nominees) rather than brokers. Finally, brokers are obligated to correctly adjust basis regardless of whether corporate issuers fulfill their duty to report the effect of corporate actions on basis.

Wash sales also complicate basis calculations. A wash sale generally occurs if a taxpayer sells a security at a loss and acquires a "substantially identical" security within a 61 day period beginning 30 days before the date of the sale and ending 30 days after the date of the sale. The wash sale rule prevents a taxpayer from recognizing the loss on the sale. Instead, the deferred loss results in a basis and holding period adjustment to the newly acquired securities that triggered the wash sale. Wash sales routinely occur in investor portfolios as securities are bought and sold. Even a dividend reinvestment can trigger a wash sale. The new cost basis law includes two simplifying assumptions that can be overridden by the IRS—brokers must compute wash sales based on only identical securities rather than substantially identical (as determined by CUSIP), and must only

compute wash sales occurring within the same account. In spite of these simplifications, the basis adjustments to both the wash sale loss deferred stock sale and the subsequent disposition of the wash sale triggering purchase, as well as the holding period adjustments, may be beyond the capabilities of many existing brokers' reporting systems.

When a customer transfers its holdings from one broker to another, the new law requires the transferring broker to provide the recipient broker with a written statement that includes the information the receiving broker will need to comply with the new law within 15 days of the date of the transfer. This transfer statement requirement is effective at essentially the same time as the new basis reporting law.

There are several important aspects of this new transfer statement requirement. First, the transferor essentially has to be able to do potentially all the sorting and computations described above in order to provide the receiving broker with the information that it will need. Second, the IRS has the power to require persons other than brokers to provide transfer statements (see the definition of "applicable person" under new Internal Revenue Code Section 6045A(b)). The exercise of this expanded power could result in various persons in the transfer agent arena that hold stock on behalf of customers, but who are not treated as brokers for Form 1099-B purposes being obligated to provide transfer statements (and make the necessary basis computations) when their customers transfer stock to brokers. Third, there will be a demand to expedite the delivery of, and convert the written statement into a standardized electronic format that brokers can easily process. There will likely be significant growing pains regarding formatting and the type of information provided as both the related broker basis systems are revised and IRS guidance is issued.

The discussion set forth above is merely a quick summary of the more readily apparent issues of significance for stock transfer agents. IRS guidance that could substantially impact the amount of work that needs to be done or affect who is obligated to do it may be issued in stages and some important details may not be finalized until 2010 or later. However, stock transfer agents that are already preparing Form 1099-B as brokers will have a significant challenge in preparing to meet their obligations under the new law, particularly relating to corporate actions and wash sale basis adjustments. And, depending on the scope of future IRS guidance, others in the stock transfer agent arena could become subject to cost basis reporting obligations in connection with transfers of stock to brokers, and they would also need to develop and implement the systems to track basis information and deliver it to brokers within 15 days of a stock transfer.

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