Cost Basis Reporting Law: IRS Comments

An Overview

A Wolters Kluwer Financial Services Whitepaper

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Executive Summary

On February 6, 2009, the Internal Revenue Service ("IRS") released Notice 2009-17, IRB 2009-8, inviting public comments on 36 specific issues under eight categories, as it formulates guidance relating to the cost basis reporting legislation, which was enacted into law as part of the Emergency Economic Stabilization Act ("EESA") in 2008. As these categories and comments will impact the soon to be issued IRS guidance about the law, it is essential that leaders in the brokerage community understand them to implement a solution in time for the January 1, 2011 initial effective date. This executive summary offers a high-level overview of the eight categories and some of the specific issues. This paper provides insight into the public comments offered by leading industry organizations, including SIFMA, ICI & FIF, vendors and individuals around these topics.

Applicability for Reporting Requirements

The cost basis reporting law will expand the universe of parties subject to broker reporting related obligations, due primarily to the broad definition of brokers that have access to cost basis information, as well as to a potentially broader definition of applicable persons for transfer reporting under a new, related tax code provision. In the call for public comments, the IRS requested input around applicability on: how to determine who is a middleperson subject to basis reporting; who, in addition to brokers, should be treated as "applicable persons" subject to transfer reporting; and, whether an issuer's classification of an instrument should determine which effective date applies.

Basis Method Election

A tax lot relief method determines which lot of stock or securities — and its associated basis, is used in computing gain or loss on a sale. To comply with the law, brokers may be required to handle all tax lot relief methods allowed by the IRS for determining the basis of securities sold. Additionally, brokers will need the ability to apply different lot relief methods to different security types. In the call for public comments, the IRS requested input relating to basis method elections on: ensuring that customers are adequately informed of a broker's default basis determination method and that brokers are adequately notified of a customer's election of a method other than the broker's default; facilitation of a customer's alternative election to both maximize customer flexibility and minimize broker burden; discussion around changing from average cost basis to another method; and the implication of applying basis determination on an 'account by account' basis.

Dividend Reinvestment Plans

For dividend reinvestment plan stock (DRIP shares), the central issue is the expansion of average cost basis as a method beyond mutual fund shares to include DRIP shares. Relative to DRIPs, the IRS requested input on: the determination of what qualifies as an "arrangement" that is a DRIP; determining which stock qualify as "acquired in connection with" a DRIP; the extent to which the average cost basis method applies to subsequent additions to DRIP; and discussion around single-account election for stock acquired in connection with a DRIP or in a RIC, where basis and holding period information for pre-effective date stock is weak or unclear.

Reconciliation with Customer Reporting

Reconciliation is the matching of the taxpayer's gains and losses on the Schedule D of the 1040 with the broker's 1099B. Over the years, the IRS has been enthused about the prospect of improving their audits by matching the numbers that are reported to them through the 1099 process for gross proceeds, dividends and interest with the numbers that are reported to them by the taxpayers through the 1040 process. Relative to reconciliation, the IRS requested input on: how to ensure maximum consistency on Form 1099-B and Schedule D on Form 1040 reporting; how to address pre-effective date securities; ensuring reconciliation when there are differences; and, whether, after a sale, customers may change the identification of specific stock sold and, if so, for what period of time.

Special Rules & Mechanical Issues

This topic includes a variety of issues relating to wash sales, options, changes in timing for reporting proceeds from short sales, adjustments to basis for original issue discount, market discount, premium and additional special basis adjustment rules. The particular items present some of the most difficult technical issues. Relative to special rules & mechanical issues, the IRS requested public comments on: the scope of the wash sales exception, including the definition of "identical securities", the wash-sale period, and any de minimis or other exceptions; applying the rules for options; the change in timing for reporting of short sales; challenges with foreign basis reporting; and addressing mechanical issues relating to a variety of other instruments.

Transfer Reporting

The new law imposes reporting requirements when a broker transfers securities to another broker. For example, when a customer transfer his or her account from one broker to another, their securities move from broker A to broker B, and new code section 6045A requires broker A to provide transfer information, including cost basis, about the transferred securities to broker B within 15 days of the date of transfer. Relative to transfer reporting, the IRS requested public comment on: what information should be required on the transfer reporting statements; whether fifteen days is the proper period for furnishing transfer reporting statements; application for partial lot transfers; electronic utilization of third-party reporting services; and, how to deal with non-covered securities in transfer reporting.

Issuer Reporting

Internal Revenue Code Section 6045B of the new cost basis law mandates that issuers report corporate actions to brokers. There are a number of cases where the issuer does not provide a tax opinion to the market to determine whether the corporate action is taxable or how it affects basis. However, one critical aspect left out of the law is details about what should be reported to the IRS. The law provides that the IRS should address this aspect in regulations. Relative to issuer reporting, the IRS requested public comments on: what information should be required; how to maximize the timeliness of issuer returns; how to account for basis-changing organizational actions by foreign issuers; and coordinating broker transfer reporting with issuer corporate action reporting to avoid duplicate broker adjustments when accounts are transferred.

Broker Practices & Procedures

The cost basis reporting law presents some additional obligations and potential penalties to brokers. Relative to broker practices & procedures, the IRS requested public comments on: the extent that a broker should verify reasonableness of basis information; procedures around non-covered securities; procedures around account transfer reporting including insufficient or untimely reporting of corporate actions; under what circumstances penalties may apply to brokers or other reporting entities; and when relief from penalties should be available.

Introduction

On February 6, 2009, the Internal Revenue Service ("IRS") released Notice 2009-17, IRB 2009-8[1], inviting public comments on 36 specific issues under eight categories, as it formulates guidance relating to the cost basis reporting legislation, which was enacted into law as part of the Emergency Economic Stabilization Act in 2008[2]. The eight categories in the Notice are: Applicability for Reporting Requirements; Basis Method Election; Dividend Reinvestment Plans; Reconciliation with Customer Reporting; Special Rules & Mechanical Issues; Transfer Reporting; Issuer Reporting; and Broker Practices & Procedures.

Generally the IRS issues proposed guidance and subsequently invites comments. Here, they asked for comments first. Issuing this request less than six months after the law was enacted is a positive development that indicates that the IRS is actively working on developing guidance. It suggests that the IRS understands the urgency around issuing guidance, so that broker system and software updates can be made in time to meet the January 1st, 2011 initial effective date deadline[3].

In general, cost basis reporting legislation was intended to reduce the tax gap and to promote tax simplification for individual return filers. It requires broker reporting that tracks the principal adjustments to basis — wash sales and corporate actions, for covered securities. To support consistent reporting, the legislation simplifies wash sale reporting and revises lot relief method determinations. In addressing the issues set forth in the Notice, promoting consistency between broker basis reporting on information returns and customer basis reporting on tax returns is a priority.

This paper considers the Notice's eight categories and the 36 questions within each, and offers perspective on many of the comments that have been submitted.

Applicability of Reporting Requirements

The cost basis reporting law will expand the universe of parties subject to broker reporting related obligations, due primarily to the broad definition of brokers that have access to cost basis information, as well as to a potentially broader definition of applicable persons for transfer reporting under a new, related tax code provision. Under Internal Revenue Code Section 6045, 'broker[4]' is a tax term of art. Under this definition, many in the brokerage community and in the securities operations community could be considered brokers, including some not typically thought of as such. For example, mutual fund complexes and other market participants, such as custodians, can easily be classified as brokers under the definition applicable for 1099B gross proceeds reporting. If someone is already subject to 1099B reporting, they will have an obligation under the cost basis law. Additionally, broker basis reporting may apply to parties who know the cost of securities and are in the securities operations chain, even if they are not considered brokers and currently do not have a Form 1099B reporting obligation.

For example, paying agent Y currently reports the gross proceeds for broker Z on Form 1099B when a customer's securities are sold. Broker Z knows the acquisition cost of the securities that are sold. But paying agent Y does not. In this case, does broker Z have an obligation to report basis on the securities sold? Does paying agent Y have this obligation? Or, are they both responsible?

The IRS Requested Comments on:

1. How to determine who is a "middleman" subject to the broker reporting and transfer reporting statement requirements and how to minimize duplication of reporting by multiple brokers;
2. Who, in addition to brokers, should be treated as "applicable persons" subject to the transfer reporting requirements;
3. Whether the issuer's classification of an instrument (e.g., as stock or debt) should determine which effective date applies.

Highlight of Comments on Applicability:

Most comments to date support a broad definition of broker and applicable persons. For example, comments from key industry associations including IRPAC[5] and SIFMA[6] specifically support a broad definition of broker and applicable persons. Additionally, Wolters Kluwer Financial Services recommends that the definitions of a broker subject to basis reporting and an applicable person under Sec. 6045A be broadened to minimize gaps in coverage. This apparent agreement on the desirability of broad reporting obligations masks a lack of agreement on assessing the responsibility for the accuracy of the ultimate information provided to the IRS.

Currently, there are no specific comments regarding how to share the information among multiple brokers and how to assess the responsibility for correctness. If regulations are proposed with the broad definition of covered individuals as applicable persons or brokers, it is possible that additional comments pushing back on the broad definition would be issued.

There is broad agreement among the comments that classification of a security as debt or equity for determination of effective date and application of basis rules, should be provided by the issuer of the security. Additionally, there is general recognition that hybrid instruments and investment units that are sold together but that are treated as comprised of multiple financial instruments for tax purposes, should be excluded from reporting, unless or until the IRS issues guidance regarding their treatment.

Basis Method Elections

A tax lot relief method determines which lot of stock or securities — and its associated basis, is used in computing gain or loss on a sale. To comply with the cost basis reporting law, brokers may be required to handle all tax lot relief methods allowed by the IRS, (including FIFO and specific identification, plus single-category and double-category averaging for mutual funds and for dividend reinvestment plans — DRIPS), for determining the basis of securities sold. Additionally, brokers will need the ability to apply different lot relief methods to different security types, such as mutual fund and dividend reinvestment plan (DRIP) shares (which are eligible for basis averaging).

The IRS Requested Comments on:

4. How to ensure that customers are adequately informed of the broker's default basis determination method and that brokers are adequately notified of a customer's election of a different acceptable method for an account;
5. How to facilitate customer elections of acceptable basis determination methods, including average cost basis, for an account to maximize customer flexibility and minimize broker burden;
6. Whether and under what circumstances a customer may elect to change from the average cost basis method to the first-in first-out or specific identification method, and, if so, what cost basis rules and adjustments should apply;
7. What it means to apply the basis determination conventions on an "account-by-account" basis.

Highlights of Comments on Basis Method Election:

There is generally consensus among the comments recommending flexibility in how customers indicate their determination of methods and how they communicate their preferences to the brokers. As a general matter, the comments, including SIFMA's[6], recommend that the lot relief method be selected before a customer's first trade in an account.

There is additionally concern about who makes the averaging election. Some comment letters suggest that the broker would be the sole entity deciding whether averaging would be available. Regarding average cost, most comments recommend against allowing a customer to change from the average cost method once established in an account.

For averaging, brokers can make a "single account election" to include pre-effective date shares, eliminating the need to maintain two averaging 'buckets', which would simplify the calculations. However, the comments express concerns relating to the quality of older data, and some suggest allowing a lower standard of cost basis quality for pre-effective date data.

A number of comments, including those from ICI[7], raise concerns around whether data would still be available in cases when a broker has already done calculations based on averaging, and, after some period of time, the customer wants to change to FIFO or specific ID. Comments suggest that it generally would not be workable to have to restate and represent all the individual lots that existed previously once an account had been averaged, and some recommend that the IRS permit the use of a new average basis for the shares previously averaged if a customer is permitted to discontinue averaging.

An additional consideration echoed by a number of comments suggests prospectively eliminating the double category method of averaging. Although the two methods for averaging mutual funds have been in the IRS regulations for some time, single category averaging is used by most if not all existing mutual funds. The comments note that if the industry is not using the double category method, there may not be a benefit to retaining it as an additional customer option that could require additional broker system processing functionality. Further, the STA[8] notes that averaging might not be workable for DRIP shares due to a variety of mechanical issues and did an excellent job raising their concerns in their comment letters.

Dividend Reinvestment Plans

For dividend reinvestment plan stock (DRIP shares), the central issue is the expansion of average cost basis as a method beyond mutual fund shares to include DRIP shares. It is essential to determine whether shares constitute DRIP shares due to the different effective date (DRIP shares acquired on or after January 1, 2012 are subject to broker basis reporting in lieu of the earlier effective date generally applicable to stock) and the availability of the basis averaging for such shares. In effect, brokers need this information immediately in order to code both ordinary stock and DRIP shares and to treat them properly under their applicable rules and effective dates.

The IRS Requested Comments on:

8. How to determine what qualifies as an "arrangement under which dividends on any stock are reinvested in stock identical to the stock with respect to which the dividends are paid" (that is, as a "dividend reinvestment plan");
9. How to determine which stock qualifies as "acquired in connection with" a dividend reinvestment plan, for which the average cost basis method is available beginning in 2011, and to which the later effective date of 2012 for information reporting applies;
10. Whether and to what extent the average cost basis method applies to subsequent additions to dividend reinvestment plan accounts by purchase or transfer;
11. How to maximize the utility of the single-account election for stock acquired in connection with a dividend reinvestment plan or stock held in a regulated investment company, particularly where basis and holding period information for pre-effective date stock is weak or unclear.

Highlights of Comments on DRIPS:

In general, most comments raise concerns regarding administration of the rules for DRIP plans, including how a broker would distinguish eligible shares of an issue from non-eligible shares of the same issue. IRPAC[5] and SIFMA[6] particularly focus on these considerations. IRPAC[5] suggests the possible expansion of the DRIP rules to cover those other shares and perhaps extend them to periodic investment plans. SIFMA[6] suggests that it should be the broker's decision whether to allow DRIP averaging. The STA[8] comments raise some additional questions about whether extending averaging to DRIP shares is workable or appropriate. Wolters Kluwer Financial Services comments recommend that stock is treated as DRIP stock only for customers who have elected to participate in a DRIP plan, and that only stock that is paying dividends at the time the issuer or broker begins offering a DRIP qualifies as DRIP stock. Further, other shares held by the customer that are not in a DRIP plan should not be included in

the averaging calculation. Additionally, they suggest that subsequent deposits or acquisitions of stock into a DRIP plan should be combined into a single aggregate averaging pool. Wolters Kluwer Financial Services comments also recommend penalty relief and a lower, good faith standard of care for data from pre-effective date shares that are included in an averaging pool due to the single account election.

The bottom line of these comments is that the result could be a relatively narrow application of the special rules for DRIPS. Full implementation of the DRIP rules would involve fairly complex interaction of broker customer elections and consequences of transfers of DRIP shares from one brokerage account to another.

Reconciliation with Customer Reporting

Reconciliation is the matching of the taxpayer's gains and losses on the Schedule D of the 1040 with the broker's 1099B. Over the years, the IRS has been enthused about the prospect of improving their audits by matching the numbers that are reported to them through the 1099 process for gross proceeds, dividends and interest with the numbers that are reported to them by the taxpayers through the 1040 process. However, reconciliation of those two sets of numbers needs to be done well and effectively, or else the objectives of taxpayer help and audit administration could be defeated. Because of the complexities of computing basis, the IRS seemed concerned regarding additional difficulties that could arise in reconciling cost basis information reported on Form 1099-B with amounts reported by taxpayers on Schedule D.

The IRS Requested Comments on:

12. How to ensure that broker reporting on Form 1099-B and customer reporting on Schedule D of Form 1040 are maximally consistent, including whether brokers should report separately for securities subject to basis reporting or report the basis of securities that are not covered securities; for example, securities purchased by their customers prior to 2011;
13. How to ensure consistency between customers making specific identification of securities sold or transferred and broker reporting;
14. How to ensure that reconciliation is possible if broker reporting should differ from customer reporting;
15. Whether customers, after a sale, may identify or change the identification of specific stock sold and, if so, for what period of time or by what deadline.

Highlights of Comments on Reconciliation:

For a variety of reasons, there might be differences between the cost basis numbers reported by the broker to the taxpayer and to the IRS on Form 1099-B and the cost basis numbers the taxpayers report to the IRS on Schedule D of their tax returns. For example, some questions arise like the ICI's[7] observation that taxpayers under present law are not required to use the same lot relief methods used by their brokers.

What if a taxpayer wants to use specific ID or average cost reporting, and the cost basis reported by their brokers or mutual funds on Form 1099-B is based on a different method? The ICI[7] comments ask for clarification as to whether or not taxpayers can 'follow their own road' on this issue. Likewise, there are lots of adjustments that might occur that a broker would not be aware of. For example, if a customer has identical securities in accounts at different brokerages, the customer could incur a wash sale at one broker due to the acquisition of identical stock at another brokerage. Brokers are not required to adjust for such "separate account" wash sales under the cost basis reporting law but taxpayers must make such adjustments in completing Schedule D. Further, there may be other differences such as basis adjustments a taxpayer will report on Schedule D because the taxpayer acquired stock or securities as a gift or through a death without the broker's knowledge. Although IRS guidance has not yet been issued, it does not appear that brokers will be required to report cost basis adjustments for gifts and deaths on Form 1099-B.

There might be very good reasons for differences in the cost basis numbers that the taxpayer wants to report to the IRS and the numbers that the brokerage firm is reporting on Form 1099-B. One of the interesting observations is that there is going to be a fair amount of pressure on brokers to explain how they calculated the information reported to the IRS and to their customers. The AICPA[9] observes in their most recent set of comments that the technical problems should not be underestimated in terms of computing and explaining cost basis numbers to taxpayers. Further, they note that these technical challenges may cause problems for the IRS as well as for many in the banking and mutual fund businesses when dealing with customer questions about cost basis numbers reported.

Additionally, many comments suggest that taxpayers ought to 'flag' to the IRS when they are reporting numbers differing from those furnished by brokers. Comments by IRPAC[5] and others suggest modifying the Schedule D to accommodate this. For example, adding a new column with a taxpayer check box could address this consideration. Further, reconciliation raises issues as to how the IRS would deal with such explanations on an audit basis.

For consistency purposes, Wolters Kluwer Financial Services' comments suggest that brokers should report cost basis using the lot relief method used by their customers, and thus should support all available lot relief methods for such reporting. Additionally, their comments recommend greater specificity of reporting to provide detailed basis and gross proceeds information consistent with the requirement to report the short-term portion of gain or loss and the long-term portion of gain or loss, along with detail regarding any wash sale deferral affecting basis in connection with each sale transaction. These comments also suggest that reporting for sales transactions should be broken out between the portion of a sale that relates to noncovered securities and the portion that relates to covered securities, with no change in the manner of reporting the gross proceeds portion of such transactions relating to noncovered securities.

Finally, some of the questions on effective dates will likely plague the transition. For example, there are different effective dates for options reporting and for stock reporting. What is the effective date for computing basis adjustments relating to when an option is converted into stock? How will those basis adjustments for the premiums paid for the options be reflected in the stock basis, if at all? Clearly there are important transition issues and a lot of difficult reconciliation questions to be addressed.

Special Rules & Mechanical Issues

This topic includes a variety of issues relating to wash sales, options, changes in timing for reporting proceeds from short sales, adjustments to basis for original issue discount, market discount, premium and additional special basis adjustment rules. The particular items present some of the most difficult technical issues. Hence, comments were deferred on many points.

The IRS Requested Comments on:

16. The scope of the wash sales exception, including the definition of "identical securities" (including identical options), the wash-sale period, and any de minimis or other exceptions;
17. How to apply the rules for basis reporting of options;
18. Whether rules, including transition rules, are required to address the change in timing for reporting of short sales from the date the short sale is entered into to the date the short sale closes;
19. How to address mechanical issues relating to the computation of basis, such as adjustments for debt securities (for example, as a result of original issue discount, market discount, acquisition premium, or bond premium), gift-related adjustments, death-related adjustments, section 1043 basis rollovers, regulated investment company and real estate investment trust distributions representing return of capital, regulated investment company load adjustments, and the mark-to-market method of accounting for securities;
20. What, if any, translation conventions or computation adjustments should be allowed when securities are purchased with foreign currency in an account subject to United States taxation at the time of purchase or in an account that later becomes subject to United States taxation, for example, when an owner of securities becomes a United States citizen.

Highlights of Comments on Special Rules & Mechanical Issues:

With respect to wash sales, SIFMA[5] suggested a de minimis exception for reporting wash sales triggered by reinvestment of dividends. The ICI[7] suggested a de minimis rule for post year and share purchases triggering wash sales. Wolters Kluwer Financial Services' comments suggest that the term "identical securities" should refer only to securities with the same CUSIP number and that if a security does not have a CUSIP number (e.g., a foreign security), a comparable identification number (e.g., SEDOL) should be used.

Generally for options and debt, because of the later effective date, most comments were deferred on some of the other items. However, Wolters Kluwer Financial Services' comments generally recommend that brokers should apply present law in addressing the substantive law issues necessary to report basis for options.

Wolters Kluwer Financial Services' comments recommend that brokers should not be required to make gift and death-related basis adjustments for cost basis reporting purposes, which we believe is consistent with legislative intent. However, they note that many brokers and financial advisors currently provide gift and death-related basis adjustments to some of their customers as a customer service. They suggest that the inclusion of such adjustments promotes consistency between broker reporting and taxpayer reporting. Accordingly, they further recommend that brokers and other applicable persons within the meaning of Sec. 6045A should be permitted to make gift and death-related basis adjustments (although such adjustments would not be required). They suggest that such reporting could eliminate potential audit inquiries that could otherwise arise if the taxpayers report a higher basis due to step-up on death, for example, in connection with the sale of inherited stock.

For gift and death based adjustments, commenters generally support optional inclusion, rather than mandatory conclusion. This relates to some of the reconciliation issues and concerns about late information resulting in return of capital adjustments to prior based information.

For short sales, Wolters Kluwer Financial Services' comments also recommend the first applicable effective date year should be a transitional year, to avoid differing types of reporting of short sales involving the same type of underlying security (such as stock). They also recommend that basis adjustments for debt securities (original issue discount, market discount, acquisition premium and bond premium) should be required, because they are fundamental to the computation of gain or loss on the disposition of debt securities. However, they express concern that the reporting of such adjustments without taking into account the specific purchase prices or various elections of the holders of debt securities would not address the policy goals of consistency and simplicity behind the basis reporting legislation.

Further, they recommend that a similar optional inclusion of Sec. 1043 adjustments (for the sale of property by government officials to comply with conflict rules) could be permitted to be made for basis reporting purposes by brokers and other applicable persons in a manner similar to that regarding gift and death-related basis adjustments. They do not believe such adjustments should be required. They also recommend a revision of Form 8824, to set forth the reduced basis of reinvestment securities on a lot by lot basis, and that the taxpayer be required to give a copy of Form 8824 to persons holding those securities.

Return of capital basis adjustments were another area of concern. Wolters Kluwer Financial Services' comments additionally recommend that return of capital information should be treated as a corporate action subject to Sec. 6045B reporting, in order to provide such information as timely as possible to brokers, and that such information should reconcile with amounts reported in Forms 1099-DIV. They also recommend that persons responsible for cost basis reporting, including applicable persons in the case of transfers, should be required to use reasonable efforts to reflect return of capital adjustments in the cost basis of stock. In addition, they suggest that the amount of return of capital adjustments should be separately stated. They recommend that brokers be required to take into account capital loss recharacterizations as long-term for regulated investment company ("RIC") and real estate investment trust ("REIT") shares pursuant to Secs. 852(b)(4) and 857(b)(8), and that they should be permitted to determine holding periods based on the acquisition date for the stock. They also recommend that brokers be required to properly account for load charges, in accordance with Sec. 852(f) with respect to sales and purchases of front-end load RIC shares. They generally recommend excluding mark-to-market securities and taxpayers from broker cost basis reporting.

Additionally, when securities are transferred to an account with a U.S. broker from an account with a non-U.S. broker, they recommend that the U.S. broker should request cost basis information from the account holder. If the account holder fails to provide the requested information, the broker would then be required to identify the reason for the omission of cost basis information in the return with respect to a later sale of the securities.

Transfer Reporting

The new law imposes reporting requirements when a broker transfers securities to another broker. For example, when a customer transfer his or her account from one broker to another, their securities move from broker A to broker B, and new code section 6045A requires broker A to provide transfer information, including cost basis, about the transferred securities to broker B within 15 days of the date of transfer.

A key question is what information will be required in customer account transfer (ACAT) reporting? Due to the staggered effective dates, this raises considerations around DRIP stock and mutual fund shares, and around what separates a regular share stock from a DRIP stock, as one has a different effective date and one is eligible for averaging. Additionally, with hybrid securities, (such as an investment unit or a derivative, foreign securities and privately placed securities), what will the cost basis computation and reporting obligations be for brokers under the law? Another essential consideration is that brokers are responsible for adjusting basis for corporate actions. Issuers of securities will be subject to reporting of corporate action information to the market for brokers to comply with the law. While it may sound easy in theory, in practice, transfer reporting — that hand-off of information when a customer moves accounts to different brokerage firms, will involve inclusion of lots of different pieces of data from multiple sources.

The IRS Requested Comments on:

21. What information about the transferring person, the customer, the security transferred, and the underlying lots should be required on the transfer reporting statements;
22. Whether fifteen days is the proper period for furnishing transfer reporting statements, and under what circumstances a different time period, if any, should apply;
23. Whether the basis determination rules and customer elections governing sales of securities should apply equally to transfers of securities, for example, when a customer transfers some, but not all, holdings of a security to another broker;
24. Whether electronic transfer reporting may be appropriate and, if so, whether a common format should apply;
25. Whether brokers and transferring parties may utilize reporting services of third-party intermediaries to meet their transfer reporting requirements;
26. Whether the transferring person should communicate any information or justification to the transferee broker when no transfer reporting statement is required because the security is not a covered security.

Highlights of Transfer Reporting Comments:

SIFMA[6] identified 18 different data points that would need to be transferred. Wolters Kluwer Financial Services' comments listed 24 data inputs. These two sets of inputs did not overlap completely. Under the statute, all account information is to be transferred within a 15 day period. Concerns have been raised with considerations around events like corporate actions. In the cases of a reorganization or a stock split that affects the basis, who would be responsible for making those adjustments to the basis — the transferor broker or the transferee broker? Additionally, how should noncovered securities be handled? The initial effective date of January 1, 2011 really leaves out of play all the securities purchased before that date. Many brokers and mutual funds would like to report that information. If that information is reported to their customers, will the information be transferred? If so, how will the transfer of pre-effective date information be identified? These are questions that are all pending before the IRS.

Wolters Kluwer Financial Services' comments recommend that very detailed information should be included in connection with transfer reporting so that the receiving broker can accurately compute cost basis and required adjustments for corporate actions and wash sales for covered securities due to the penalty risk to such broker on later reporting the sale of the transferred securities. Further, these comments suggest that brokers should be encouraged to provide cost basis information as soon as possible after securities are transferred, (such as by the close of the next business day after the date of the transfer), due to the potential difficulties with reconciling information received later with intervening events and transactions. They also suggest that there may be extenuating circumstances that justify relief from the transfer reporting deadline in certain limited cases. They further suggest that a different standard of reporting should apply to non-brokers who are subject to Code Sec. 6045A reporting and who do not regularly provide transfer reporting information to brokers. Additionally, they recommend that there be no general limitation on the lot relief methods available when a customer transfers some but not all securities to another broker, and that the information should be provided electronically, rather than on written or printed statements. Further they recommend that brokers should be able to utilize the reporting services of third-party intermediaries for cost basis transfer reporting purposes without limitation, and, that in order for Sec. 6045A to work for the transferee, a document should be received from the transferor in all cases, even for noncovered securities.

Issuer Reporting

Internal Revenue Code Section 6045B of the new cost basis law mandates that issuers report corporate actions to brokers. Issuer reporting rules are a little bit different than transfer reporting, and there are several major concerns with issuer reporting. The reason for issuer reporting, to level set, is that brokers have to adjust basis for corporate actions. With respect to the way that corporate actions are communicated, there are a number of cases where the issuer does not provide a tax opinion or a tax disclosure statement to the market or to holders that they can look at to determine whether the corporate action is taxable or how it affects basis. However, one critical aspect is that it left out details about what is reported to the IRS. The law provides that the IRS should address this aspect in regulations.

The IRS Requested Comments on:

27. What information about the issuer and organizational action should be required on the issuer returns and reporting statements;

28. How to maximize the timeliness of issuer returns and statements and promote public reporting by issuers in lieu of return filing;

29. How to account for basis-changing organizational actions by foreign issuers of securities to the extent that foreign issuers are not subject to the issuer reporting requirements;

30. How to coordinate broker transfer reporting with issuer corporate action reporting to avoid duplicate broker adjustments when accounts are transferred and whether a universal timing standard should apply.

Highlights of Issuer Reporting Comments:

The SIFMA[6], the IRPAC[5], Wells Fargo[10] and Wolters Kluwer Financial Services' comments really laid out a number of important details about the actions that they thought should be reported, as well as details about taxability. Key consideration include: what code section; treatment of US holders; specificity about whether basis has increased or decreased; and, if the basis is allocated as a percentage, requests for that percentage. Additionally, overriding is a request from issuers for a tax opinion or a statement on the impact of corporate actions on securities for tax purposes.

A critical consideration is how to maximize the timeliness of giving this issuer reporting information to the marketplace. This is a significant issue because with the issuer reporting rule, 6045B, issuers have 45 days from the corporate action to submit a return to the IRS. However, they do not have to tell the record holder of the security about the corporate action until January 15th of the following year. Relative to corporate actions reporting in the brokerage space, this is far too late. Normally, corporate action adjustments should be made on the same day the action occurs, as supported by many comments.

Additionally, the SIFMA[6] and Wolters Kluwer comment letters both suggest public reporting of corporate actions, ideally on a website, and that this information should be provided to corporate action vendors in the marketplace, so that they can disseminate it through the brokerage community. Further, for some types of issuers, such as foreign issuers, they suggest that depositories could be used to require provision of tax information, since it may be difficult to get it from the foreign issuer. SIFMA[6] also suggests a default rule, so that if the foreign issuer does not give a tax opinion, then there is an assumed treatment. There were also concerns about privately placed securities because of the lack of the information. In the Wolters Kluwer Financial Services' comment letter, a wait and hold approach is suggested, due to the concern about getting that information from all issuers.

Wolters Kluwer Financial Services' comments additionally suggest that issuers should not be required to provide precise mathematical computations of adjustments to basis. They point out that this would seem to replicate the task of brokers and could be problematic, given the differences in facts, valuations and allocations that could apply to specific customers, due to their particular circumstances.

Further, they recommend that privately issued specified securities should not be subject to issuer reporting under Sec. 6045B or to broker basis reporting under Sec. 6045(g), unless and until the IRS has considered the appropriate rules for both issuers and brokers under the cost basis reporting law. They recommend that the treatment of corporate actions by foreign issuers not subject to Sec. 6045B be treated as a separate project.

They also recommend that the private sector be encouraged to adopt a uniform protocol for timing the capture of corporate action information with respect to transferred securities. Further, they recommend that a transferring broker identify the date of the last corporate action booked relating to each security transferred to assist the receiving broker in determining whether it has or must make a pending corporate action adjustment to securities received.

Broker Practices & Procedures

The cost basis reporting law presents some additional obligations and potential penalties to brokers. For example, what responsibility does a brokerage firm or a mutual fund have to make sure that the cost basis numbers that they are sending are correct and are as good as they can make them? Further, when does a broker have to start correcting numbers or look for more information? Additionally, is there an affirmative obligation on the broker's behalf to do so?

The IRS Requested Comments on:

31. To what extent a broker should verify the reasonableness of basis information and what document retention requirements should apply;

32. What procedures a broker should follow if the broker derives basis and holding period information for or from customers with respect to a security that is not a covered security, including potential reporting of such information to either the customer or the Service;

33. What procedures a transferee broker should follow if the broker does not receive a transfer reporting statement;

34. What procedures a transferee broker should follow if the broker receives transfer reporting information with respect to a security that is not a covered security, or from a transferor who is not subject to the transfer reporting requirements;

35. What procedures a broker should follow with respect to basis adjustments if an issuer report on a corporate action is insufficient or untimely;

36. Under what circumstances penalties may apply to brokers or other reporting entities and when relief from penalties should be available.

Highlights of Broker Practices & Procedures Comments:

Relative to providing correct information, most of the comments suggest the level of effort that is necessary should be a reasonable effort and that information should be kept so long as the information is material and not an unreasonable or overly burdensome obligation for a broker to either collect or to retain that information. For example, Wolters Kluwer Financial Services' comments recommend that a broker be required to use reasonable effort to obtain an issuer report on corporation actions.

There have been many suggestions to the IRS that the new obligations imposed on brokers ought to be kept to a minimum and there has been a request for penalty relief across the board. Present law has penalties of $50 per return with a $250,000 cap with waivers of any penalties for failure due to reasonable cause. The IRS is likely to come out with some sort of penalty relief that follows or tracks present law pretty closely, although many have requested for even greater relief. For example, Wolters Kluwer Financial Services' comments recommend that if it appears that the issuer fails to provide the information in a timely fashion, and that to the extent brokers do not receive needed corporate action reports from issuers and must make determinations regarding the effect of such actions on basis on their own, that brokers should be subject to a lower reasonable efforts standard of care for relief from information return penalties

Wolters Kluwer Financial Services' comments also suggest that the IRS establish a reasonable period of time for record retention, such as five years rather than indefinite retention, that brokers may collect information on non-covered securities for or from a customer, and that such information be shared with the customer (with a proper disclaimer). Further, IRPAC5 suggests that there should be outside comment on the design of the revised 1099B form and on the broker transfer forms. They focus particularly on problems that brokers would have in expanding gross proceed reporting to S corporations that have not been broken out separately from other C corporations under current law.

Wolters Kluwer Financial Services' comments further recommend that brokers and other applicable persons within the meaning of Sec. 6045A should be permitted to make gift and death-related basis adjustments (although such adjustments would not be required), that the IRS provide for a single account-type election (comparable to that set forth in Sec. 1012(c)(2)(B)) to include pre-effective date securities to all brokers for any security at a broker's election.

Additionally, the comments generally acknowledge that there are a variety of ways that the information might be missing or incorrect that need to be addressed. For example, in the cases of the transfer reports and the issuer reports, there might be wrong or missing information.

Conclusion

Intended to raise revenue without raising taxes, to reduce the tax gap and to promote tax simplification for individual return filers, the cost basis reporting law includes complexities that must be addressed promptly so that brokerages can make the necessary system and software updates to meet the January 1st, 2011 initial effective date deadline[3]. By releasing Notice 2009-17, IRB 2009-8[1] inviting public comments about aspects of this law, the Internal Revenue Service ("IRS") is demonstrating an understanding of the urgency to issue guidance. Clarification via guidance on the 36 topics within the eight categories covered by this Notice and reviewed in this paper is essential to the industry to meet the compliance deadlines.

NOTE: All referenced comments are public information and are additionally accessible on www.costbasisreporting.com.

NOTE: A special thank you to comment author Stevie D. Conlon, Tax Director, GainsKeeper, part of Wolters Kluwer Financial Services.

[1] IRS Notice 2009-17 IRB 2009-8.

[2] As set forth in Internal Revenue Code Sections 6045(g) and (h), 6045A, 6045B and 1012(c) and (d) (hereafter "Sec." shall generally refer to a section of the Internal Revenue Code).

[3] For additional information about the tiered phase-in dates and the law, visit www.costbasisreporting.com.

[4] Under Internal Revenue Code Section 6045, 'broker' is a term of art. Under this definition, many could be considered 'brokers', including some not typically thought of as such, including mutual fund complexes and other payors. Actual reporting obligation generally falls to the last person defined as a broker making the payment to an eligible recipient. Therefore, in terms of responsibility, you can almost think of it like a 'last in line' approach. So the responsible party – or broker - can be thought of as the 'last in line,' or the one who last delivers payments to the taxpayer.

[5] Information Reporting Program Advisory Committee

[6] Securities Industry and Financial Markets Association

[7] Investment Company Institute

[8] Securities Transfer Association

[9] American Institute of Certified Public Accountants

[10] Wells Fargo & Company

To learn more about the cost basis reporting law, visit www.costbasisreporting.com
To learn more about GainsKeeper, visit www.gainskeeper.com.

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