



Q & A Recap:

A Call to Action: an Industry Under-Prepared

Wednesday, October 14, 2009

Why C-Level Executives Should be Concerned about the New Cost Basis Reporting Rules

By Celent Senior Analyst David L. Easthope

IRS GUIDANCE

1. Question: Is there any information on the status of the IRS guidance and when the guidance is expected to be issued?

Answer: Although we don't have anything specific on when guidance will be released, we are aware that a number of industry groups have outreached to the IRS and have had dialogue about development of the guidance.

It is expected that IRS guidance will be in the form of proposed. Although they are far enough along with the guidance that they are no longer soliciting comments since this law impacts so many tax areas (from 1099s to financial instruments, products, accounting), there are many senior people above the actual guidance working group who need to sign off before guidance is released, (which will hopefully be before end of the year).

One caution is not to expect that any forthcoming guidance from the IRS in the near term will be complete. Instead, we expect that it will be a first cut of proposed regulations and that the IRS will want to know what people and the industry think of it before issuing the final set of rules that we seek. It is also likely that the guidance may not be comprehensive or cover all of the topics posing challenges. Certain sections of the proposed regulations may be omitted and "reserved" as placeholders for future IRS guidance.

2. Question: We have been given to understand that the IRS will soon be releasing their guidelines to questions and concerns raised by STA and other groups. Do you have any current information on the expected release of the guidelines?

Answer: See answer to question 1.

3. Question: What do you say about the significant amount of outstanding IRS guidance that is pending? A lot of it is what we consider "critical path" in designing the correct solution.

Answer: See answer to question 1.

4. Question: If the IRS takes more than a few more months to finalize the laws, should we expect extensions on the Jan 1 2011 date to allow for proper development to match changing expectations?

Answer: The cost basis reporting law has a firm effective date. The law does not provide for any IRS extensions on the effective date. Cost basis reporting was enacted as a revenue raiser and the early deadline accounts for a portion of the estimated \$6.7 billion in potential tax revenue. Any consideration of extending the deadline would likely need to take into account the impact of the extension on estimated tax revenue and would likely require legislation. This could be difficult given current estimates of pending and future federal deficits.

LOT RELIEF SELECTION

5. Question: To qualify for the exception to the "FIFO" tax lot selection, do we have to receive an individual direction from each client or could we provide clients with a notice of our preferred tax lot methodology and have them "opt out" if they have a different direction.

Answer: As a general matter, the cost basis reporting law has different sets of lot relief rules depending on the type of stock held. First, you need to determine if it is regular stock, a security or an option. Or, determine if it is a mutual fund share or dividend reinvestment plan (DRIP) stock, (although we are still waiting for the IRS to define what DRIP stock is for cost basis reporting purposes).

For regular stock, bonds and options, FIFO is the default, and customers can direct an alternative to their brokers on a case by case basis. If it is a mutual fund share or DRIP share, the broker chooses the default relief method and notifies the customers who can then elect out

We are also waiting for guidance on how customers and brokers communicate the lot relief method to the each other as well as how long customers have to elect out of broker selected methods for mutual fund and DRIP shares.

6. Question: Will the shareholder be permitted to elect a lot relief method at the CUSIP level, or can we have them elect it at the account level instead?

Answer: Currently, the law is at a stock-by-stock or CUSIP level. However, we are waiting for guidance on this, so we don't know if a general election applicable to all securities within a customer's account would be allowed. The brokerage community, in dialogue with IRS, seems to have indicated that they want to preserve customer flexibility regarding lot relief methods. Waiting for, and then implementing the rules regarding such elections are some of the difficulties the industry is facing.

7. Question: Is it anticipated that IRS will permit taxpayers to change their allocation method up through the time of the individual's tax return filing?

Answer: Current tax law generally requires a taxpayer to select a lot relief method and communicate it to his or her broker at the time of (or within a reasonable time after) the trade. However, the IRS has permitted a taxpayer to correct and change lot relief selection up to but no later than the settlement date of the trade. Given this restriction, current law does not appear to permit taxpayers to change their allocation method later, such as up through the time of tax return filing. Given IRS guidance under existing law, it would be surprising if the IRS issues cost basis reporting guidance that permits taxpayers to change their allocation method up through the time of tax return filing.

8. Question: For managed products, can the broker make the tax lot relief method election on behalf of the customer or does the customer have to make it?

Answer: The law requires that the taxpayer makes the election for lot relief methods other than FIFO for stocks, debt and options. The election to opt-out of a lot relief method chosen by a broker for mutual fund or DRIP stock must also be made by the taxpayer. The law does not specifically address or seem to contemplate having a broker make the election on a customer's behalf on managed products. Hopefully, IRS guidance regarding the details of lot relief method selection and the opt-out will address this issue. However, it would not be surprising if this detail is not addressed in the first round of pending IRS guidance.

FOREIGN INSTRUMENTS/CURRENCY

9. Question: Do you have any advice specific to foreign based Qualified Intermediary (QI) Brokers on this topic? The main concern for us is cost. With such a small fraction of client base being US persons requiring 1099-B reporting, the costs are prohibitive.

Answer: There is no carve-out or exception for foreign based brokers. It appears that any person that is considered a broker under the gross proceeds reporting rules and currently obligated to file Form 1099-B would also be subject to cost basis reporting under the new law. There have been comments submitted to the IRS raising concerns regarding the burden of this obligation on qualified intermediaries.

10. Question: Will securities purchased with foreign currency be subject to Cost Basis Reporting?

Answer: Based on how the law is written, there is no exclusion in the definition of securities subject to cost basis reporting based on what the currency denomination is or what currencies the securities are purchased with. Our comment letter requests exclusion of foreign securities from basis reporting due to the complexities of the computation of basis related to currency. However, unless the IRS provides an exemption or temporary relief via guidance, foreign securities purchased with foreign currency would be subject to cost basis reporting.

ACCOUNT BIFURCATION

11. Question: What did you mean by bifurcation of accounts relative to the law?

Answer: Bifurcation of accounts relative to the law is how we distinguish between old securities, not subject to the cost basis reporting law, and newly acquired securities purchased on or after the related effective dates. As a result, there is a need to track newly purchased holdings because the sale of these securities will require a broker to provide the Form 1099 cost basis reporting information. The technical term in the law is 'covered' securities versus 'uncovered' securities. This in essence, 'divides' each customer's account into two separate pools: older 'grandfathered' securities that are not subject to cost basis reporting, and more recently purchased securities that are subject to cost basis reporting.

ACCOUNT TRANSFER

12. Question: What are the anticipated best practices for transferring cost basis information between custodial firms? (Bank to Broker/Broker to Bank).

Answer: We can't speak to best practices standards. These will be part of an industry effort and will likely take time to develop given that the law is new and IRS guidance has not yet been issued. However, we can talk about the basic requirements for transfer reporting under the cost basis reporting law. The letter of the law is that the transferor custodian has 15 days after the date securities are transferred to another broker to provide cost basis reporting information to the transferee, and issuers of specified securities have until January 15th of the year following the year in which a corporate action occurred to provide a tax return reporting corporate actions to holders. (Issuers must file such a return with the IRS within 45 days after the date of the corporate action).

WASH SALES

13. Question: Where in the supply chain would cost adjustments on wash sales fall? Would it fall on the taxpayer, their custodian or broker/manager? If not the taxpayer, would it be because the burden is really on the issuers of the 1099-B ?

Answer: One of the complexities of the new law is that the wash sale adjustment is going to be an obligation of the broker. The broker has to compute the wash sale deferral and basis adjustment for reporting on the Form 1099-B. However, regardless of what the broker sends, the taxpayer has an obligation to correctly adjust for wash sales. Additionally, the wash sale rule that applies to brokers for cost basis reporting purposes is simplified, applying only to wash sales relating to identical securities occurring within a single customer account. If, however, the taxpayer holds the same or substantially identical securities in different accounts, they are obligated to track wash sales across such accounts. So the adjusted basis information a taxpayer may be required to report under the wash sale rule may be different from that reported by brokers on Form 1099-B in certain cases. However, for the bulk of investors, the wash sale burden is essentially placed on the broker under the new cost basis reporting law.

REITS

14. Question: Do these rules apply to non traded REITs?

Answer: Yes. The cost basis rules apply to all stock. Shares or beneficial interests in a real estate investment trust (REIT) are treated as stock for federal income tax purposes. Moreover, the cost basis reporting rules do not include any exemption for non-publicly traded stocks or securities. Thus, the cost basis reporting rules would appear to apply to non-traded REIT shares. There might be concerns regarding corporate action reporting compliance or obtaining information for non-publicly traded stocks and securities that could make cost basis reporting for such stocks and securities difficult. Our comment letter suggests exempting non-publicly traded stocks and securities from cost basis reporting due to these concerns.

DISCLAIMER: The questions set forth above are general in nature and are not intended as legal, tax, or professional advice. Although based on the law and information available as of the date hereof, general assumptions have been made by GainsKeeper which may not take into account potentially important considerations to specific taxpayers. Therefore, the questions presented above may not be appropriate for you. Readers must also independently analyze and consider the consequences of subsequent developments and/or other events. Readers must always make their own determinations in light of their specific circumstances.

Copyright 2009, Wolters Kluwer Financial Services

www.gainskeeper.com

www.woltersklowerfs.com

