
Broker Basis Reporting Proposed Legislation: Simplification by Decree—Details to Come

*By Stevie D. Conlon**

Stevie Conlon looks at broker basis reporting proposals in both their current forms and the relevant background. She also lays out some of the concerns, focusing on the technical legal issues.

The President's budget for Fiscal 2008 was released on February 5, 2007. In the budget's tax provisions was a proposal to require brokers to provide adjusted basis reporting to the IRS and taxpayers on Forms 1099 for security sales (the "President's proposal").¹ IRS Commissioner Mark Everson indicated in congressional testimony that the basis reporting proposal was one of the four most important tax-related legislative changes proposed by the president.² Under the President's proposal, basis reporting would apply to securities acquired after December 31, 2008, and the budget estimates that the proposal would result in \$6.7 billion of additional tax revenues over a 10-year period.³

While only a small part of a much larger and politically controversial "tax gap," the \$6.7 billion of potential expected revenue to be gained from the President's proposal would seem intuitively attractive to Congress. It is believed that taxpayers underreport their capital gains and losses from stocks and securities sales and that the proposal would address such underreporting. It has also been stated that the basis reporting proposal promotes tax simplification.⁴ This

is fairly clearly accomplished by shifting the burden of computing adjusted tax basis for stocks and securities from taxpayers to the brokers obligated to prepare the proposed adjusted basis information on Forms 1099. In classic legislative style for tax issues of any complexity, this is essentially done under the proposal by decree—since most of the details of basis reporting are left to be fleshed out in hopefully soon-to-be-issued regulations by the IRS.⁵

The inclusion of a basis reporting proposal in the 2008 budget is a significant development given a recent series of events discussed below. However, the President's proposal is subject to several challenges. For example, the last significant legislative expansion of the Form 1099 rules in 1982 was the subject of substantial broker industry consternation and the industry has raised, and will likely continue to raise, concerns regarding the proposal.⁶ In addition, the basis reporting proposal would also apply to mutual funds and require reporting to the IRS and taxpayers regarding mutual fund shares. Legislative proposals raised in the 1990s to expand mutual fund share reporting ultimately died in committee and were subject to industry criticism, and it is likely the mutual fund industry now has its own concerns regarding the current basis reporting proposal as well. Some of the concerns raised are technical legal issues—related to complexities of tax law or access to information necessary to compute adjusted basis. Others are technology-based—related to the costs, development and interfaces with existing computer information systems used to track investors' accounts that will be needed to properly report adjusted basis information to the IRS and taxpayers.

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As discussed below, the President's proposal is not alone. Broker basis reporting proposals were introduced in the House and Senate last year and again this year. And the Joint Committee on Taxation offered its own variation in a report on the tax gap delivered to the Senate Finance Committee in 2006.

This article focuses on broker basis reporting proposals in both their current forms and the relevant background. It also lays out some of the concerns, focusing on the technical legal issues. This article does not discuss legislative proposals to index cost basis for inflation.

Background

Information reporting has been part of the tax law since 1917, but the scope of required information reporting ebbed and flowed during the Great Depression and World War II.⁷ The last significant expansion of the information reporting rules occurred with the enactment of the Form 1099-B gross proceeds reporting requirement under current Code Sec. 6045 as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).⁸ At that time, the securities industry raised concerns that such reporting would impose significant record-keeping obligations on brokers and questioned whether the IRS could even process the information received.⁹ Nevertheless, the Form 1099-B gross proceeds reporting rules were enacted in 1982 and computer technology and recordkeeping has made many advances since then.

In 1990, economist Gene Steuerle published an article advocating that Congress enact a single method for computing gains and losses on disposition of mutual fund shares and requiring mutual funds to calculate gains and losses for shareholders.¹⁰ He stated that dividend reinvestments and the ease of withdrawals resulted in complicated basis and gain computations that were prone to investor error. He also indicated that the different choices an investor had for determining his or her basis in shares sold (such as FIFO, specific identification or average cost) may have made mutual funds reluctant to assist in making related gain or loss computations.

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In 1993, a bill was introduced in the House, H.R. 13, titled the "Tax Simplification Act of 1993," that included special basis rules for shares of stock in open-end regulated investment companies.¹¹ These special rules would have mandated the use of the average basis for certain stock in computing gain or loss. Related provisions included a proposed amendment to Code Sec. 6045 that would have required Form 1099 reporting of average basis and holding period for open-end regulated investment company shares.¹² The average basis and related reporting provisions were not enacted.

In both 1996 and 1997, President Clinton's budget proposals for fiscal years 1997 and 1998 included a proposal to require taxpayers to use the average basis of substantially identical stocks and bonds for computing gain or loss.¹³ However, this proposal did not require brokers to report basis information.¹⁴

The Investment Company Institute commented that it was strongly opposed to the average cost basis proposal because it would disadvantage many taxpayers by preventing them from specifically identifying lots of stock sold for purposes of computing gain or loss, and would also increase complexity due to the inclusion of dividend reinvestment shares and stock held by related persons in computing average cost.¹⁵ The Securities Industry Association similarly opposed the average cost basis proposal.¹⁶ The average cost basis proposal was not enacted during that time.

Recent Developments

In August 2005, Gene Steuerle published a follow-up article titled *Improved Information Reporting for Capital Gains*.¹⁷ In the article, he advocated information reporting by mutual funds of capital gains relating to shareholder transactions involving fund shares in part based on two key arguments—that information systems had sufficiently advanced from the time of his earlier article 15 years ago to readily facilitate such reporting and that in fact some mutual funds were already providing limited forms of such gains reporting to some of their shareholders (although no reports that could be used for matching were being provided to the IRS). He also suggested that such

reporting could be expanded to require brokerage firms to report gains and losses on stock sales. And he stated that basis reporting complexities such as dividend reinvestments should be administrable given advancements in computers and brokerage accounting systems. As before, he suggested the use of a single basis computation method—averaging by each customer account. He acknowledged some potential complications but stressed the benefits resulting from simplification for taxpayers and improved taxpayer compliance.

On January 10, 2006, Taxpayer Advocate Nina Olsen submitted her annual report to Congress for 2005 on the state of the tax system from the taxpayer's perspective.¹⁸ The legislative recommendations section of the report included a section titled "Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds."¹⁹ The report justified the recommendation as follows:

For taxpayers, tracking basis can be extraordinarily complex and many taxpayers seeking to comply with the law find they simply cannot do so with accuracy, leaving them exposed if audited. From the government's perspective, the absence of information reporting enables underreporting by taxpayers who deliberately overstate their basis (thereby reducing their gain or even generating a loss), because they know the IRS generally cannot detect errors in basis reporting in the absence of an audit.²⁰

The report stated that one estimate indicated a \$250 billion revenue loss over 10 years from such underreporting.²¹ The body of the report included four examples of how taxpayer reporting of basis in computing gains and losses could result in complexities or revenue loss to the Treasury: (1) adjustments to basis due to automatic reinvestment of regular dividends and capital gains distributions from mutual fund investments; (2) automatic monthly mutual fund shares purchases and regular redemptions of fund shares; (3) basis adjustments due to complex corporate actions such as mergers and reorganizations as demonstrated

by the spin-off of AT&T and subsequent mergers and acquisitions of the baby Bells; and (4) tax cheating via overstatement of basis as demonstrated by failing to take into account the reduction in per share basis due to simple corporate actions such as stock splits.²² Consistent with Mr. Steuerle's proposal, Ms. Olson's report suggested that Congress or the IRS could mandate a single method of determining cost basis of stocks and securities.²³

In February 2006, Joseph J. Thorndike published his article *Wall Street, Washington & the Business of Information Reporting*, detailing the history of basis reporting and ending with the conclusion that "[m]any of the complaints long associated with basis tracking ring hollow in the modern information age."²⁴

2006—Senator Bayh's Proposed "START" Act

On March 14, 2006, Senator Bayh (Indiana), along with Senators Obama, Carper, Kerry and Levin, cosponsored S. 2414, the Simplification Through Additional Reporting Tax Act (the "START Act").²⁵ In introductory remarks, Senator Bayh echoed earlier comments by Gene Steuerle regarding the feasibility of such reporting, noting that "[i]f Fidelity or Ameritrade or E*Trade can provide cost basis information to all of their clients, it clearly suggests that the information can be provided."²⁶ He also reiterated the argument

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that such reporting would result in tax simplification for individuals receiving such reports.

The START Act legislation died in committee with the close of the 109th Congress at the end of 2006, but surrounding it was the submission to congressional committees of reports, letters and testimony relating to basis reporting and its potential benefits of simplification and increased taxpayer compliance as a partial solution to the tax gap. The START Act legislation was essentially reintroduced in the Senate on February 14, 2007, as S. 601.²⁷

Details of the START Act

The START Act would modify Code Sec. 6045 relating to reporting of gross proceeds by brokers on Forms 1099-B to additionally generally require brokers to

report the customer's adjusted basis for "applicable securities."²⁸ Applicable securities are defined as stocks, debt instruments, interests in regulated investment companies (mutual fund shares) and other financial instruments as designated in regulations.²⁹ The reporting rules would not generally apply to partnership interests, options, swaps or other derivatives (although the introductory remarks indicate that the IRS could decide to include them).³⁰

The IRS would have the legislative authority to issue regulations requiring brokers to exchange account information with other brokers in order to provide adjusted basis information for customers that transfer their accounts from one broker to another.³¹ The START Act would also grant the IRS the authority to issue regulations or other guidance to exempt brokers from the reporting requirement in cases where they do not have the information necessary to meet the rules. Such IRS authority appears extremely broad and could require the reporting by brokers of other information or could exempt classes of cases where there is insufficient information to provide the desired information.³² The introductory remarks suggest that this authority was intended to exempt brokers from providing Form 1099-B information for transactions such as gifts and wash sales (acknowledging the complexities in computing basis under such cases).³³

The proposed effective date of the START Act was for securities acquired after December 31, 2007. Thus, Form 1099-Bs including adjusted basis information would need to be delivered to taxpayers in January 2009. Based on when the legislation was introduced, it was anticipated that there would be close to two years before stock and securities acquisitions would become subject to the proposal and three years before the first Form 1099s would be due. The introductory remarks indicated that this was intended to provide brokers "ample time, to put the processes and systems in place to comply with this new regulation."³⁴ The remarks also anticipated potential criticism and commentary from the securities industry.

More Recent Developments—The GAO Report and Joint Committee on Taxation Proposal

The introduction of the START Act proposal and the legislative recommendation set forth in the National Taxpayer Advocate's Report resulted in the consideration of basis reporting by congressional committees on several occasions during 2006 and into 2007.

On June 13, 2006, David Walker, Comptroller General of the United States, testified before the Senate Finance Committee regarding tax compliance and basis reporting³⁵ and provided a General Accountability Office (GAO) report on the issue (the "GAO report").³⁶ The GAO report examined an IRS study of calendar year 2001 tax return data that indicated an \$11 billion tax gap due to taxpayer misreporting of income from capital assets. The GAO report analyzed the extent to which misreporting was related to stocks, bonds and mutual fund distributions.

Based on the IRS data for 2001, the GAO estimated that 38 percent of individual taxpayers misreported their capital gains and losses from securities transactions.³⁷ The GAO also determined that in about half the cases the taxpayer misreported at least \$1,000 of capital gains and losses and that in about half the cases the taxpayer misreported gains and losses because they failed to accurately report the stock or security's basis—either because they did not know it or because they did not take into account adjustments to basis. In addition, in about nine percent of the cases the taxpayer misreported gains and losses as long-term and short-term. The GAO recommended "that Congress consider requiring brokers to report adjusted basis to taxpayers and IRS and requiring IRS to work with the industry to develop cost effective ways to mitigate reporting challenges."³⁸ The GAO essentially repeated these points in testimony and submissions before Congress regarding the tax gap in early 2007.³⁹

On August 3, 2006, the Staff of the Joint Committee on Taxation (JCT) provided a report titled "Additional Options to Improve Tax Compliance" to the Senate Finance Committee in response to the Senate Finance Committee's concerns regarding the so-called tax gap.⁴⁰ Among its diverse assortment of proposals, it included its own version of broker basis reporting (the "JCT proposal"). The JCT proposal would apply to a slightly different and likely broader and more inclusive defined class of securities as compared to the START Act. First, it would only apply to securities that are publicly traded on an established securities market, and, second, it would apply to a greater range of securities types as compared to the START Act. The proposal would have applied to (1) shares of stock (including mutual fund shares); (2) partnership interests and beneficial ownership interests (including interests in limited liability companies, real estate investment trusts or similar passthrough entities); (3) notes, bonds, debentures or other

evidences of indebtedness; and (4) evidences of an interest in, or a derivative financial instrument in, any security described in 1 through 3 above, including any options, futures contracts, short positions and any similar financial instruments in such securities.⁴¹ The American Bar Association Tax Section submitted comments regarding the JCT proposal on March 15, 2007 (the “ABA Comments”), and recommended that the publicly traded requirement be dropped and that the definition of securities subject to reporting should be the same as the existing definition applicable to broker Form 1099-B reporting.⁴²

The JCT proposal explicitly addresses limitations on brokers’ account based data systems by providing that computations of basis for purposes of computing gain or loss under either the generally available first-in/first-out and specific identification methods set forth in Reg. §1.1012-1 (as well as the averaging methods permitted for mutual fund shares under such regulation) would be based only on the securities held in a single account, regardless of whether the taxpayer holds identical securities in another account (even if with the same broker). The ABA Comments recommended that the basis of mutual fund shares (but not other shares) and partnership interests subject to reporting would generally be computed based on single-category, single-account averaging (although the proposal might provide broker option of using specific identification of shares method).⁴³ The JCT proposal also contemplates reporting requirements applicable to securities issuers so that brokers have adequate information to provide basis reporting.

The JCT proposal notes that basis adjustments due to wash sales under Code Sec. 1091 and post calendar year-end return of capital adjustments for prior year distributions create basis adjustments that could pose problems for brokers and that special rules may be appropriate. Significantly, the ABA Comments recommended that brokers report “broker observed cost” rather than adjusted basis to specifically address practical limitation with computing basis adjustments due to certain tax rules affecting basis that could be affected by tax law complexities or facts that might be outside the scope of information known by the broker such as wash sales, straddles, holder-specific original issue discount, market discount and bond premium elections (among other things).⁴⁴ The JCT proposal also suggested that the IRS may need to develop new forms with additional detail relating to groups of securities including grandfathered securities to capture basis information appropriately and raised concerns regarding

the ability of the IRS to store and process the volume and detail of basis information reported.⁴⁵

The JCT proposal provided for an 18-month transition period so that it would only apply to transactions involving securities purchased 18 months or more after the date of enactment.⁴⁶ Interestingly, the ABA Comments suggest generally applying the new rules to all securities held after an initial effective date delay (but treating older securities as transferred in from a broker)—presumably to better manage computer systems issues relating to the effective bifurcation of all customer accounts between grandfathered and subject securities.⁴⁷

During 2006 and early 2007, academics and the AICPA also submitted favorable comments regarding broker basis reporting. For example, Rutgers University Professor of Taxation Jay Soled testified at a September 26, 2006, Senate Committee Hearing in favor of the START Act and pointed out several items not addressed in the GAO report. First, he noted that if security ownership continued to expand, incorrect capital gains and loss reporting could result in incorrect tax return filings by almost four out of every 10 individuals.⁴⁸ Second, he noted that the GAO Report only focused on individuals and thus by negative inference raised concerns regarding potential underreporting by corporations and other types of entities. He thought that this could increase the size of the estimated annual loss from \$11 billion to more than \$25 billion.⁴⁹

On January 5, 2007, the American Institute of Certified Public Accountants (AICPA) submitted comments to the Senate Finance Committee on the several proposals intended to help close the tax gap by the JCT, including basis reporting under the JCT proposal.⁵⁰ The AICPA supported basis reporting under the JCT proposal but noted that the technical problems in connection with adopting the proposal should not be underestimated.⁵¹ The AICPA comments suggest that the information reported should be provided in a format that could be downloaded directly to tax return preparation software and permit taxpayers to electronically notify brokers regarding particular lots of securities that they want sold under the specific identification method to address potential inconsistencies between broker computations of tax basis and the taxpayer’s.⁵²

Not all the comments received were wholly supportive of the broker basis reporting proposal. For example, the Securities Industry and Financial Markets Association (SIFMA) submitted comments

setting forth a number of suggested revisions to the broker basis reporting proposal to the Senate Finance Committee in a letter dated November 30, 2006.⁵³ The comments include an initial discussion of the limitations of existing basis reporting by brokers and the proposals include statutory authority to phase in the rules, statutory authority to permit the IRS to waive or modify the rules as appropriate, disconnecting the reporting from Form 1099-B gross proceeds reporting, imposing mandatory corporate actions reporting by issuers of securities, providing a method for addressing mismatches between broker reports and taxpayer returns, and additional transitional relief for small brokers.⁵⁴ The comments also recommend extending the period between enactment and effectiveness of the new reporting rules from 18 months to a greater, but unspecified period.⁵⁵ Tax Executives Institute also recently provided testimony before the IRS oversight board on the tax gap and included comments on expanded IRS reporting, saying in part that before expanding such reporting “the IRS should be able to demonstrate its ability to use effectively the information it already receives and, by extension, the additional information that will come its way.”⁵⁶

On January 23, 2007, the GAO provided additional testimony and analysis relating to the tax gap to the Senate Budget Committee, including the basis reporting proposal.⁵⁷

The President’s 2008 Budget Proposal on Basis Reporting

In light of recent developments, the inclusion of a broker basis reporting proposal as part of the President’s 2008 budget could be viewed as no surprise. At this point, details of the proposal are scant because there is no actual bill or proposed statutory language and there is only a single paragraph describing it.⁵⁸ Given the lack of specifics, it is not clear to what extent the President’s proposal differs from either the START Act bills or the JCT proposal.

The President’s proposal would apply to certain publicly traded securities—it is unclear whether this would track the JCT proposal or whether the particular classes of securities or the definition of publicly traded would differ. Like the earlier proposals, the IRS would be granted authority to provide exceptions to the rules. Unlike either the START Act or the JCT proposal, the President’s proposal would also require brokers to provide security acquisition and disposition dates to permit the IRS to track holding periods and short-term/long-term capital gains and losses. Brokers would be obligated to transfer needed information to successor brokers when accounts are transferred. The President’s proposal would exempt brokers from providing information that they were unable to obtain by reasonable efforts. The proposal also

Senate Finance Committee Releases Staff Cost Basis Reporting Proposal

On Friday, May 25, 2007, the staff of the Senate Finance Committee released its own cost basis reporting proposal (the “Senate Finance Staff Cost Basis Proposal”)—both proposed bill language and a related technical explanation prepared by the Joint Committee on Taxation. The Senate Finance Staff Cost Basis Proposal is more detailed than the other proposals. It includes proposed bill language and a technical explanation of the provision.

In many respects, the Senate Finance Staff Cost Basis Proposal appears to follow the Administration Cost Basis Proposal released in February. Cost basis reporting would require brokers to report the holder’s adjusted cost basis and holding period information for securities disposed or exchanged, and would apply to securities acquired by purchase, gift, inheritance or other means. Cost basis reporting would apply to more than publicly traded stocks and bonds, mutual fund shares and SEC registered real estate investment trust (REIT) shares. It would also apply to options, shorts, forwards, derivatives and partnership interests, provided they are publicly traded. In a change from present law, the proposal would also provide that existing gross proceeds reporting rules and the proposed cost basis reporting rules would apply to options and for payments to corporate recipients.

The Senate Finance Staff Cost Basis Proposal would apply to securities acquired after the date that is 18 months after the date of enactment.

provides that the IRS could establish rules requiring customers to provide certain information to brokers that relates to adjustments in basis or customer cost when the broker has no other way of obtaining the information. The President's proposal also includes a sentence indicating that basis adjustment information affecting an entire class of securities could be provided through either the issuer of the securities or a central repository. Finally, the President's proposal would apply to securities acquired after December 31, 2008. Form 1099s would need to be completed for such securities in January 2010.

Of course, the extent to which the President's proposal will morph into something different during this legislation season or what any actual proposed statutory language may reveal is not yet known.

Areas of Concern

Types of Securities Subject to Reporting

As indicated above regarding the JCT proposal, the ABA has raised concerns regarding the public trading requirement. It should be noted that the focus is whether particular securities are traded on an established securities market, which is not always as clear as some might believe, particularly with regard to certain over-the-counter stocks and many debt securities where trading is thin.⁵⁹

Also as discussed above, the JCT proposal included many securities besides stocks and debt instruments, including certain derivatives such as options and certain partnership interests. Does the President's proposal follow suit? This is unclear. The expansion of reporting to such securities seems somewhat novel. Certainly, basis adjustments for partnership interests are more complicated.⁶⁰

Broker Recordkeeping and Data Processing System Limitations

This is a practical issue of significance. However, as indicated at the outset of this article, the focus here is on technical legal issues rather than these practical issues, which are more appropriately addressed by information systems and software specialists who are familiar

with the intricate details of broker tax lot accounting systems and the computer systems related to the preparation and formatting of Form 1099 returns. Thus, the consideration of the issue here shall merely be from a high altitude standpoint. SIFMA and others have raised concerns regarding the ability to implement broker basis reporting given existing broker recordkeeping and data processing systems limitations. It appears that the legislative proposals principally address this

matter by providing for an approximately 18-month period between enactment and the required delivery of broker basis reporting returns. The \$64,000 question is whether this is enough time. And requests for extending this period have already been made.

Note that the ABA Comments recommend that existing securities be subject to basis reporting once the new rule is effective to simplify broker accounting system recordkeeping by eliminating the need to separate customer account holdings into grandfathered and those subject to the new rule baskets.⁶¹

Require Averaging for Computing Basis or Permit Taxpayers to Select Method

When a holder owns more than one lot of securities, it must be determined which particular lot is deemed sold so that the proper tax basis is used in computing gain or loss. Reg. §1.1012-1(c)(1) and (3) generally requires that taxpayers must use a first-in/first-out (FIFO) method unless they adequately identify the particular lot that they desire to have sold and receive a written confirmation of that identification from their broker (specific identification). Not all brokers necessarily provide the written confirmation to permit taxpayers to use specific identification. A taxpayer may generally elect to use one of two different averaging methods for mutual fund shares held (see Reg. §1.1012-1(e)(3) and (4)).

Of course, the existence of different options complicates the determination of basis of shares and securities when they are sold. Which method is the taxpayer using? If taxpayers can select different methods, shouldn't the forms indicate the method used to the IRS? Or should things be simplified by requiring the use of only a single method? Of course, such an approach

Concerns have been raised regarding the cost of providing the necessary tax information upon the transfer of customer accounts from one broker to another.

would prevent taxpayers from choosing the method that is most advantageous from a tax standpoint. So the critical questions are whether the broker accounting and reporting systems can adequately apply the different methods, what is the relative cost of building in this functionality, and whether the IRS can track and follow the method selected. Note the ABA Comments suggest that averaging be required for mutual fund shares under the single-category, single-account method and that a presumption for other shares held be used based on FIFO while continuing to permit taxpayers to use specific identification.⁶² Under the ABA Comments, brokers would also be allowed to use the single-category, single-account averaging method for nonmutual fund shares and the tax return information would need to specify the method selected.

Multiple Accounts and Holdings of Identical Securities

Consistently, commentators have noted that a broker's ability to correctly report basis is in part dependent on knowledge of other holdings of identical securities by the taxpayer. A broker presumably generally has no knowledge of taxpayer holdings with other brokers. A taxpayer could also have holdings with nominees or through family members or entities that could need to be considered, and these holdings also appear clearly beyond the expected scope of knowledge of a reporting broker. And brokers' accounting systems may have practical problems tracking and computing tax basis for separate accounts held by the same broker for a single taxpayer. In all of these cases, a simplifying assumption of permitting broker reporting based on single accounts has generally been proposed.⁶³ Clear guidance in the proposed statutory language and legislative history is critical to avoid the risk of IRS regulations or guidance that is unduly restrictive due to the agency's inherent concerns regarding adhering to the letter of existing law and risk of taxpayer abuse.

Transfers of Accounts from One Broker to Another

Concerns have been raised regarding the cost of providing the necessary tax information upon the transfer of customer accounts from one broker to another. The importance of this information to implementing a proper system is apparent due to its highlighted status in the various proposals. It has been noted that systems to provide this information could be comparatively more burdensome for smaller brokers and the ABA Comments have suggested some alternatives.⁶⁴

Corporate Actions Information Generally

This is another lynchpin issue because as noted in both the Taxpayer Advocate report and GAO report, it is the failure of many individual taxpayers to correctly adjust the basis of their holdings for corporate actions that often results in underreported capital gains on dispositions of stocks and securities.⁶⁵ The basis reporting proposals transfer the burden of tracking and properly adjusting for corporate actions from individuals to brokers. Many brokers already have corporate actions groups that track these events as a customer service for certain classes of customers. The basis reporting proposal would effectively transform these efforts from a value-added optional service to a requirement for the large class of individual account holders to which basis reporting would apply. The potential applicability of information return related preparer penalties would increase the necessary standard of care and due diligence that brokers would have to apply in tracking and adjusting their records for corporate action events. Unfortunately, as discussed below, there are two obvious areas where brokers have inadequate information to properly account for certain types of corporate action events.

Corporate Actions Information for Transactions Without Clear Tax Opinion

First, many corporate actions do not include a clear federal tax opinion regarding their tax consequences. Many small, thinly traded corporations spin off shares of other corporations and do not provide tax opinions regarding whether such distributions are taxable or tax-free (as would generally be the case if Code Sec. 355 applied, for example). In other cases, federal tax opinions are provided that indicate the treatment of a corporate action is unclear or could be determined under one or more alternatives with differing tax treatment. In all of these cases, brokers are left without the necessary information needed to properly account for potential basis adjustments that could result from such corporate actions. The basis reporting proposals all acknowledge this potential limitation and pose different alternatives to address this gap. For example, the President's proposal suggests that corporate issuers could be required to provide guidance regarding the appropriate tax treatment of corporate actions or a central repository could obtain and maintain such data.⁶⁶ However, the devil is in the

details and it will be interesting to see if the carve-out or rules ultimately developed in this area fully address this information gap.

Non-U.S. Corporate Actions Information

Here, the data gap is even more apparent. Global investments by U.S. investors in non-U.S. companies continue to grow. In many cases, such companies do not provide U.S. tax opinions regarding the U.S. federal income tax consequences of their corporate actions. Sophisticated corporate actions groups may currently engage in self-help to “guesstimate” the most likely or conservative potential U.S. tax treatment for shareholders upon such corporate actions. Of course, investors and such corporate actions groups are typically far removed from the non-U.S. companies and both distance and language or accounting rule differences may make it very difficult to obtain the necessary facts needed to properly determine the U.S. tax treatment. A carve-out is even more critical here due to this data gap because it would seem particularly unfair to subject brokers to penalty risk given the intuitively apparent inability to readily obtain the information needed to determine the proper tax treatment of corporate actions involving non-U.S. companies. This issue has been identified in the comments on the basis reporting proposals.

Wash Sales Basis Adjustments

The wash sale rule of Code Sec. 1091 essentially results in loss deferrals and basis and holding period adjustments when substantially identical stock or securities (as defined therein and under a separate parallel rule for short sales) are acquired (as defined therein) within a 61-day period centered around a loss generating disposition of stock or securities. Investors that actively purchase and dispose of stocks and securities can easily run afoul of the wash sale rule. High trading volume in an account can make the application of the wash sale rule's loss deferral and basis and holding period adjustments ripe candidates for automation and in fact a variety of tax lot accounting software providers offer programs that are intended to account for wash sales. The question is whether or not the broker basis reporting rules force brokers to apply the wash sale rules and adjust basis and holding period for wash sales. The ABA Comments recommend that brokers should not be obligated to do so and would also carve out other types of basis adjustments such as those occurring under the identified straddle rule of Code

Sec. 1092(a)(2) and other provisions.⁶⁷ The obvious point is that basis reporting that does not account for wash sales within a customer's account would seemingly provide a free pass from the rule since taxpayers and the IRS would likely generally lack either the information or the know-how to properly apply the wash sale rule (due to the same reasons that resulted in the broker basis reporting proposals). This gap in reporting detail would need to be balanced with the cost for brokers of tracking wash sales. Similar issues with a comparable sort of cost/benefit analysis would seemingly apply to other basis adjustments for stocks and securities under the Code.

Mutual Fund Sales Load Basis Adjustments

A holder's basis in his or her shares takes into account the commission paid for the acquisition of such shares. Code Sec. 852(f) includes a special rule that in certain specified cases essentially shifts the “load” (sales charge) incurred on acquiring mutual fund shares from the disposition of such shares within 91 days of the date of acquisition to subsequently acquired shares in such fund (or another fund under a reduced load). A technical issue of concern to mutual funds and their brokers relates to the impact of this rule under the basis reporting proposal and the potential concerns regarding whether computer systems could adequately track the needed adjustments to apply it. Unfortunately, the basis reporting proposals have not provided enough specificity to determine the extent to which the rules or the anticipated regulations will address it.

Waiting for Regulations and Concerns Regarding IRS Willingness to Promulgate Exceptions from Reporting

Of major concern to brokers and their tax advisors is the deferral of many details of the basis reporting proposals to IRS guidance. They appear to have two basic concerns. First, delayed guidance on many of the important details effectively shortens the time available to develop the systems and software needed to implement the reporting rules. It is typical for the IRS to take several years to issue regulations that are satisfactory to both the IRS and taxpayers, and such a delay here would effectively wipe out the contemplated 18-month preparatory period between enactment and the delivery of the first required report

under the proposal. Second, there is also concern regarding whether the IRS would craft exceptions to the rules that are as broad as brokers may believe are warranted. The history of the revised widely held investment trust regulations under Code Sec. 671 (Reg. §1.671-5) is instructive regarding potential industry concerns with IRS developed reporting rules.⁶⁸

Integration with Existing Forms 1099 Reporting

There are also a number of mechanical issues regarding broker basis reporting. For example, what form should be used? Should existing Form 1099-B for gross proceeds reporting by brokers be expanded to include the newly required information? Or should a new separate Form 1099 be developed? The inclusion of the broker basis reporting information in the existing Form 1099-B could strain existing computer-based accounting and information systems that generate and prepare the current forms. It has also been suggested that because of the lot-by-lot nature of the related basis information, that the information needed to report adjusted basis could overwhelm the existing design of Form 1099-B.⁶⁹

Grandfathered Holdings Broker Account Complexities

It has been noted that grandfathering existing holdings essentially divides every existing customer's account into two sub-accounts—an account comprised of grandfathered pre-effective date holdings and an account comprised of post-effective date acquired stocks and securities. The effective doubling of holders' accounts, and the related imposition of a required ability to determine whether securities are sold out of the post-effective or grandfathered sub-accounts for purposes of properly applying the basis reporting rules, raises concerns regarding broker tax accounting procedures and systems.

Anticipated Effective Date and Systems Development Concerns

Even if every single rule needed to implement broker basis reporting were bundled up, packaged and wrapped with a bow, and delivered on the day the

legislation was enacted, there are still many practical concerns regarding the time needed to properly implement basis reporting. Bidding for the work, prioritizing its development given other company software and systems projects, and complying with applicable company, regulatory and accounting and auditing policies regarding software development and implementation makes timely implementation of basis reporting systems a serious practical challenge, even under the best of circumstances. Brokers and their tax advisors are clearly concerned regarding these issues, and that seems totally appropriate.

Basis Reporting Proposal Is Still a Work in Progress

Of course, basis broker reporting has not yet been enacted and many of its facets have not yet come into clear focus. The proposals have changed and the comments and reports submitted indicate that there is a lot of attention on the proposals and their details. Moreover, as of the date this article was written, there is no proposed legislative language regarding the President's

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proposal. It is unclear whether, in what form, or when, broker basis reporting (whether based on the President's proposal, the JCT proposal, the START Act or some other variation) will be enacted. It is clearly a moving target and the comments and concerns identified above need to be considered in light of this current blurriness.

Conclusion

Broker basis reporting could pose many challenges for both brokers and the IRS due to the importance of computer systems and the obvious potential areas of concerns in its application described above, including limitations on corporate actions information, the impact of detailed basis adjustment rules such as wash sales, and the systems implementation issues raised both generally and with respect to transferred accounts. The estimated revenue scoring of the proposal, its role in addressing the so-called tax gap and its benefit of simplifying tax return preparation for individuals may make it attractive to many. But the

proposal promotes simplicity by shifting the burden of accurate basis reporting from individuals to brokers and currently leaves the bulk of the key details to be

determined later by the IRS. Details needed to assess the cost of implementation and the extent to which brokers' concerns will be satisfied are yet to come.

ENDNOTES

- * The author gratefully acknowledges the assistance of her colleagues Karen Davidson, Kathy Hough, Ruth Frear and Don MacGregor.
Disclosure: GainsKeeper and Wolters Kluwer Financial Services could benefit from the broker basis reporting proposal.
- ¹ White House, President's Fiscal Year 2008 Budget (Feb. 5, 2007) available at www.whitehouse.gov/omb/budget/fy2008/budget.html (Last visited April 9, 2007).
- ² Statement of Mark W. Everson, Commissioner, IRS, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means, Mar. 20, 2007, at p. 12 at <http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=5717> (Last visited April 4, 2007).
- ³ *Supra* note 1.
- ⁴ Treasury Department, General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals 64 (February 2007), available at www.treas.gov/offices/tax-policy/library/bluebk07.pdf (Last visited April 6, 2007); Nina Olson, National Taxpayer Advocate, Written Statement of Nina E. Olson National Taxpayer Advocate (2007) available at www.irs.gov/advocate/article/0,,id=125634,00.html (Last visited April 9, 2007).
- ⁵ *Id.* "The IRS and Treasury Department would be granted regulatory authority to promulgate specific rules, including exceptions, to implement this mandate."
- ⁶ Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248).
- ⁷ Joseph J. Thorndike, *Wall Street, Washington and the Business of Information Reporting*, Feb. 13, 2006, at www.taxhistory.org/thp/readings.nsf/cf7c9c870b600b9585256df80075b9dd/a518ae7d8d5eaf23852571360068fc5e?OpenDocument (Last visited April 4, 2007).
- ⁸ Act Sec. 311 of TEFRA. See note 6 *supra*.
- ⁹ Thorndike quoted a letter from the SIA: "Most financial intermediaries lack the systemic capability, storage capacity, and the key data elements (adjusted basis and date of acquisition) to make the underlying computations for the vast majority of their customers[.]" *Supra* note 7; Edward I. O'Brien, *Securities Industry Association Critiques Compliance Legislation*, 16 TAX NOTES 157 (July 12, 1982).
- ¹⁰ C. Eugene Steuerle, *The Mutual Fund Problem*, 47 TAX NOTES 609 (Apr. 30, 1990).
- ¹¹ Act Sec. 622 of the Tax Simplification Act, H.R. 13, 102d Cong. (1993).
- ¹² See Act Sec. 622(a), Tax Simplification Act, H.R. 13, 102nd Cong. (1993). The Investment Company Institute submitted papers on certain aspects of these basis reporting provisions to the Tax Legislative Counsel's Office, Dept. of Treasury. See letter from Catherine L. Heron on behalf of the Investment Company Institute to David Weisbach, Attorney Advisor, Tax Legislative Counsel, Department of Treasury, dated April 29, 1993 (available from Tax Notes).
- ¹³ See discussion in Joint Committee on Taxation Report analyzing the Revenue Provisions of President Clinton's 1998 Budget, www.house.gov/jct/s-10-97.pdf (Last visited April 6, 2007) and JCT Analyzes Revenue Provisions in Clinton's 1998 Budget Proposal, 97 TNT 74-11 (Apr. 16, 1997).
- ¹⁴ *Id.*
- ¹⁵ Statement of the Investment Company Institute on Revenue Raising Provisions of the Administration's Fiscal Year 1998 Budget Proposal submitted to the Committee on Ways and Means, U.S. House of Representatives, March 26, 1997. Similar comments were made in earlier submissions (see ICI statement to House Ways & Means dated May 15, 1996).
- ¹⁶ Statement of Robert N. Gordon on behalf of the Securities Industry Association to the House Committee on Ways and Means concerning Certain Revenue Provisions in President Clinton's Fiscal Year 1998 Budget, dated March 12, 1997, <http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/105cong/3-12-97/3-12GORDO.HTM> (Last visited April 6, 2007) and 97 TNT 49-36.
- ¹⁷ C. Eugene Steuerle, *Improved Information Reporting for Capital Gains*, 108 TAX NOTES 697, 2005 TNT 152-36 (Aug. 9, 2005).
- ¹⁸ Nina Olson, National Taxpayer Advocate 2005 Annual Report to Congress, dated Jan. 10, 2006, available at www.irs.gov/advocate/article/0,,id=152735,00.html (Last visited April 6, 2007).
- ¹⁹ *Id.*, at II-2.
- ²⁰ *Supra* note 18.
- ²¹ *Supra* note 18.
- ²² *Supra* note 18.
- ²³ *Supra* note 18.
- ²⁴ *Supra* note 7.
- ²⁵ Simplification Through Additional Reporting Tax Act, S. 2414, 109th Cong. (2006), Simplification Through Additional Reporting Tax Act, H. 5367, 109th Cong. (2006).
- ²⁶ Introductory remarks on measure, 152 Cong. Rec. S2196, 109th Cong. (Mar. 15, 2006) available at <http://thomas.loc.gov/cgi-bin/query/R?r109:FLD001:S52197> (Last visited April 9, 2007).
- ²⁷ Simplification Through Additional Reporting Tax Act, S. 601, 110th Cong. (2007), Simplification Through Additional Reporting Tax Act, H.R. 878, 110th Cong. (2007).
- ²⁸ Act Sec. 2(a)(2) adding new subsection (g)(2)(A) to Code Sec. 6045.
- ²⁹ Act Sec. 2(a)(2) adding new subsection (g)(4) to Code Sec. 6045. Stock and debt instruments are defined by cross-reference to dealer mark-to-market rule definitions set forth in Code Sec. 475(c)(2)(A) and (C).
- ³⁰ Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting, Before the S. Comm. on Finance, 109th Cong. (2006) (Statement by David M. Walker, Comptroller General of the United States), at <http://finance.senate.gov/hearings/testimony/2005test/061306testdw.pdf> (Last visited April 5, 2007).
- ³¹ Act Sec. 2(a)(2) adding new subsection (g)(3) to Code Sec. 6045.
- ³² Act Sec. 2(a)(2) adding new subsection (g)(2)(B) to Code Sec. 6045.
- ³³ *Supra* note 26, at S. 2198.
- ³⁴ *Id.*
- ³⁵ Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting Statement of David M. Walker Comptroller General of the United States (June 13, 2006) available at www.gao.gov/new.items/d06851t.pdf (Last visited April 9, 2007).
- ³⁶ General Accountability Office, *Capital Gains Tax Gap: Requiring Brokers To Report Securities Cost Basis Would Improve Compliance If Related Challenges Are Addressed* (GAO-06-603, June 2006) available at www.gao.gov/cgi-bin/getrpt?GAO-06-603 (Last visited April 16, 2007).
- ³⁷ *Supra* note 35.
- ³⁸ *Supra* note 35.
- ³⁹ *Supra* note 35.
- ⁴⁰ Staff of the Joint Committee on Taxation (JCT), Additional Options to Improve Tax Compliance (Aug. 3, 2006) available at www.finance.senate.gov/press/Gpress/2005/prg101906.pdf (Last visited April 17, 2007).
- ⁴¹ *Supra* note 40.
- ⁴² American Bar Association, Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of the Joint Committee on Taxation, 2007 TNT 52-31 (Mar. 15, 2007).
- ⁴³ *Supra* note 42.
- ⁴⁴ *Supra* note 42.

⁴⁵ *Supra* note 40.

⁴⁶ *Supra* note 40.

⁴⁷ *Supra* note 42.

⁴⁸ Closing The Capital Gains Tax Gap: Hearing Before the S. Comm. on Homeland Security and Governmental Affairs 109th Cong. (2006) (Testimony by Jay A. Soled, Professor of Taxation, Rutgers University). Available at http://hsgac.senate.gov/_files/SoledTestimony.pdf (Last visited April 6, 2007).

⁴⁹ *Supra* note 42.

⁵⁰ Jeffrey R. Hoops, American Institute of Certified Public Accountants, *AICPA Offers Comments on JCT's Tax Gap Report*, 2007 TNT 8-32 (Jan. 5, 2007).

⁵¹ *Id.*

⁵² *Id.*

⁵³ Letter of Patti McClanahan, Vice President and Director, Tax Policy, on behalf of the Securities Industry and Financial Markets Association dated November 30, 2006, *Securities Association Offers Suggestions for Basis Reporting Requirements*, 2007 TNT 23-52 (Feb. 1, 2007).

⁵⁴ *Id.* See the letter for additional suggestions

not set forth above.

⁵⁵ *Supra* note 53.

⁵⁶ Statement of Timothy J. McComally, Executive Director, Tax Executives Institute, Inc., *TEI Says Additional Reporting Regulations Could Undermine the Tax System*, 2007 TNT 46-53 (Mar. 7, 2007). Based on the examples provided in the statement, it is not entirely clear that the comments specifically relate to the broker basis reporting proposal.

⁵⁷ Multiple Approaches Are Needed to Reduce the Tax Gap, Testimony before the S. Comm. on the Budget, 110th Cong. (2007) (Statement of Michael Brostek, Director, Tax Issues, Strategic Issues Team, Government Accountability Office.) available at http://budget.senate.gov/democratic/testimony/2007/Brostek_taxgap012307.pdf (Last visited April 6, 2007).

⁵⁸ *Supra* note 4.

⁵⁹ This concern is raised in the ABA Comments. *Supra* note 42.

⁶⁰ This is an understatement. See generally subchapter K of the Code and note the special rules for large partnerships set forth in Code

Secs. 771 through 777 for which regulations have not yet been issued.

⁶¹ *Supra* note 42.

⁶² *Supra* note 42.

⁶³ *Supra* note 42.

⁶⁴ *Supra* note 42.

⁶⁵ *Supra* note 18; *supra* note 30.

⁶⁶ *Supra* note 4.

⁶⁷ The ABA Comments carve-out "adjustments resulting from the application of section 1091, section 1092(a)(2), section 263(g), section 267(d), section 961, section 1293(d), or any other basis adjustment provision that requires knowledge of extrinsic information (e.g., other transactions or elections)." *Supra* note 42.

⁶⁸ For a glimmer of the issues, see, e.g., letter from Keith Lawson on behalf of the Investment Company Institute to Michael J. Desmond, Tax Legislative Counsel, U.S. Dept. of Treasury, dated October 27, 2006 regarding the widely held fixed investment trust reporting rules, 2006 TNT 217-28 (Nov. 9, 2006).

⁶⁹ *Supra* note 53; *supra* note 42.

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