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Preparing for the New
Cost Basis Reporting
Law:
*A Practical
Explanation*

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Cost Basis Reporting is Law

- Included as part of H.R. 1424, the Emergency Economic Stabilization Act of 2008, enacted in response to the financial market crisis
- Signed into law by President Bush on Friday, October 3, 2008 (Pub. L. No. 110-343)
- Cost basis reporting is Section 403 of the Act
- Text of cost basis reporting provision is at www.costbasisreporting.com

What Must Brokers Report?

- Brokers currently report gross proceeds for securities sales on Form 1099-B (under Code Sec. 6045)
- Law adds new Code Sec. 6045(g)
- The law requires brokers to report
 - “the customer's adjusted basis in such security and whether any gain or loss with respect to such security is long-term or short-term...”



Who Must Report?

- Same person who files current Form 1099-B
- “...any person...that...stands ready to effect sales...made by others...” (including a person that regularly retires its own debt or redeems its own stock) (“effect” means either as agent or principal)
- Examples: mutual fund; broker; custodian; escrow agent; stock transfer agent;
- Filing obligation generally rests with “last person in line” that actually makes the payment to the customer

Penalty Risks

- Tax penalty risks “raise the bar”
- \$100 per return for incorrect returns (up to \$350,000 per year)
- Greater of \$200 or 10% of amount that should have been reported if intentional disregard (with no maximum limit)
- 2 separate penalties—1 relating to forms to IRS (Code Sec. 6721) & 1 to forms to taxpayers
- Tax penalties could be increased



Effective Dates

- Staggered effective dates:
 - Stock—Jan. 1, 2011
 - Mutual fund share & DRIP shares—Jan. 1, 2012
 - Fixed income & Options—Jan. 1, 2013
- Securities covered in later effective dates require more preparation due to greater tax complexities

Effective Date Concerns

- Grandfathering and sorting—a matrix
- Separate Grandfathered (pre-effective date shares from post-effective)
- Sort different security types due to three tier phased effective date (separate DRIP & mutual funds from stock; debt and options from stock)

Need to be Ready by January 2011

- Systems must have lot relief method working to match sales with lots during 2011
- For customer account transfers during 2011, brokers must provide a statement with adjusted cost basis and holding period information to receiving broker within 15 days of transfer (This also justifies need for real time or daily system as opposed to year end batch)



Should You Wait?

- IRS guidance often takes a long time to clear internal approvals
- IRS regulations primarily interpret the law
- Law is initially effective 1/1/2011
- It would not be surprising for proposed guidance to be issued in late 2009 or early 2010—less than a year before 2011
- Guidance could be released in phases at different times



Key Requirements

- Adjusted basis must be reported (new Code Subsection 6045(g))
- Long-term/short-term gain/loss must be reported (holding period accuracy)
- Basis must be adjusted for wash sales
- Multiple lot relief methods must be supported
- Special corporate action and broker transfer reporting rules (new Code Sections 6045B & 6045A-45 & 15 days)

Lot Relief Methods - Stock

- Generally, FIFO method applies unless customer notifies broker and has adequately identified specific shares (HIFO, and other methods)
- Lot relief method is applied on by customer and by security basis



Lot Relief Methods - Mutual Fund & DRIP Shares

- Mutual fund & DRIP shares acquired on or after Jan. 1, 2012—broker determines method unless customer notifies broker and elects another method
- The customer election out means broker must provide all available methods as an option

Averaging for Mutual Funds & DRIP

- Single category or double category averaging permitted in regulations
- They have special wash sale rules
- Effective date means two averaging pools for each customer's shares—pre-effective and post-effective
- Fund (or broker as nominee) can make a “single account election” to create one averaging pool per customer's shares

Other Important Details

- Deadline for Form 1099-B delivery to customers would be changed from January 31 to February 15 (effective for 2009)
- S corporations would be treated as partnerships subject to Form 1099-B reporting purposes (effective January 1, 2012)

Some Possible Surprises

- DRIP shares eligible for basis averaging
- Holding period adjustments for wash sales
- Short sales subject to basis reporting (raises wash sale and holding period issues)
- Foreign securities subject to basis reporting
- Likely difficulties with options reporting



Corporate Actions Concerns

- Accurately tracking the impact of corporate actions on tax basis
 - Tax lot detail needed due to wash sale and short/long holding period reporting requirements
 - There are a number of different types of corporate actions and you need to have systems to track and apply the adjustments correctly to get basis and holding period adjustments correct
 - Corporate actions including REIT return of capital adjustments will need to be taken into account
- “Gap-fill” risk to brokers
 - Corporate issuers must provide corporate action basis information (Code Sec. 6045B)
 - Corporate issuers required to provide information
But what if they don't, and what about early years?
Brokers are still liable
 - How do you process corporate actions with no single answer?
 - Reporting for fractional shares



Wash Sales

- Wash sale rule defers losses and affects basis and holding period of newly acquired securities if securities are sold at a loss and within the 61 day period beginning 30 days before the date of the loss and 30 days after, the taxpayer acquires substantially identical securities
- Wash sale rules create sub-lots when lots sold are different in size from lots purchased (as is typical)
- Wash sale rules affect holding period of triggering lots
- Law requires brokers to adjust for wash sales with two key simplifying assumptions
 - Wash sales only calculated on identical (based on same CUSIP) rather than substantially identical securities, and
 - Only applied to transactions within a single account (even with same broker)



Options and Debt Securities

- Taxation of options uncharted territory & complex
 - Options with physical settlement adjust basis and proceeds of related stock
 - Cash settled options are also subject to reporting
 - Database issues with options
- Taxpayer election complexities for debt
 - Debt securities are subject to sets of tax rules for original issue discount, market discount, & bond premium that result in adjustments to basis and each taxpayer can make elections that affect the computations (even greater complexities for mortgage-backed securities & foreign currency denominated securities)



Other Special Concerns

- Special tax rules for short sales & wash sales involving short sales
 - Short sales are routine customer transactions
 - Short sales are generally taxed when closed
 - However, special wash sale rules apply (short-to-short, short-to-long and sale date rule for short-against-the-box sales at a loss)
 - Short-against-the-box transactions can also trigger constructive sales at time of short sale
- Date-of-death basis step-up calculations
- Gift basis rules
- Other special adjustments



Additional Resources

- Whitepaper:
“The New Cost Basis Reporting Law:
An Overview”
 - Available upon request via the “contact us”
link at www.costbasisreporting.com
- Copy of the law and other materials including
reprint of recent cost basis law article for
SIFMA Dividend Digest Newsletter
 - Available at www.costbasisreporting.com

Q&A

- Answers to some of the additional questions not covered at today's event will be posted at www.costbasisreporting.com



Considerations

- GainsKeeper does not provide tax advice. You should consult your own tax advisers and they (and not GainsKeeper) are solely responsible for any tax, tax penalties or interest related to their tax returns
- GainsKeeper is a tool to assist taxpayers but does not cover a variety of specific tax rules or taxpayer circumstances and facts