

Cost Basis Reporting Legislation Update

Worries & Pitfalls

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Stevie has extensive experience regarding the taxation of financial products and corporate actions and led GainsKeeper's development of its new straddle engine. Before joining GainsKeeper, Stevie was senior tax editor for CCH Capital Changes. She was formerly a tax partner at the law firms Katten Muchin Rosenman and Baker & McKenzie. Ms. Conlon is a prior chair of the American Bar Association Tax Section's Financial Transactions Committee. Stevie is the lead author of the tax law treatise *Principles of Financial Derivatives: U.S. & International Taxation*, and a member of the advisory boards for the *Journal of Taxation of Financial Products* and *Derivatives Report*. She is also the author of over 30 bylined articles focusing on the taxation of capital market financial products and has regularly been quoted in prominent industry publications & the financial press. Ms. Conlon is a member of the New York & Illinois bars and a CPA.



Overview

- ✓ Basis reporting proposal is intended to raise approx. \$9.86 billion over 10 years by providing information to IRS to make sure taxpayers comply with properly reporting gains and losses from stocks and securities sales and other taxable corporate actions
- ✓ Proposal is also intended to simplify tax return preparation for taxpayers by relieving them of burden of complicated basis calculations and tracking and shifting burden to brokers
- ✓ Proposal creates significant reporting obligations for brokers and issuers of stocks, bonds and other securities and risk of \$350k+ tax penalties to brokers and issuers for errors or failures to comply

Resources

- ✓ March 12, 2007 GainsKeeper Whitepaper
 - *Basis Reporting is Coming*
- ✓ June 11, 2007 GainsKeeper Whitepaper
 - *Senate Committee Staff Releases Cost Basis Reporting Legislation Proposal*
- ✓ September, 2007 Journal of Taxation of Financial Products article
 - *Broker Basis Reporting Proposed Legislation: Simplification by Decree—Details to Come*
- ✓ February, 2008 GainsKeeper Whitepaper
 - *Cost Basis Reporting Legislation: Close to Becoming Law*
- ✓ GainsKeeper Blog gainskeeper.com

Open Issues to be Addressed

- ✓ When is cost basis reporting legislation likely to be passed?
- ✓ What are the key details of the cost basis legislation in its current form?
- ✓ What are the important concerns for brokers?

Important Recent Indicators

- ✓ House of Representatives passed two separate bills in late 2007 that included cost basis reporting (H.R. 3996 and H.R. 6).
- ✓ Cost basis reporting also included in President's 2009 Fiscal Budget on February 4th, 2008
- ✓ Legislative staffs currently discussing cost basis legislation
- ✓ Perception is that it is “on the shelf and ready to go”

Expectations for 2008

- ✓ Tax bill expected this year (excluding recent stimulus act)
- ✓ Based on last year's bills & current staff activity, any tax bill this year is expected to include basis reporting
- ✓ House passed it last year; Senate Finance Comm. Chair & ranking Republican support basis reporting
- ✓ President's budget demonstrates his support

Recent Statements on Cost Basis

- ✓ Wall Street Journal February 6th, 2008 article quotes two tax policy consultants:
 - “Congress is highly likely to pass a basis-reporting bill this year”
 - “...it is extremely likely to be included in some tax bill this year.”
- ✓ U.S. Treasury Tax Legislative Counsel speaking at Investment Company Institute Mutual Fund Conference on March 17th 2008 said:
 - the cost basis proposal is on “the front burner”

Risks

- ✓ Tax bills could include other provisions that hold it up.
- ✓ This is what happened with the House bills passed late last year. This could happen in Senate or by Presidential veto.
- ✓ Due to election year, Congress will grind to a halt this summer.

Bottom Line

- ✓ In spite of the risks, cost basis reporting legislation is likely to be enacted this year.
- ✓ Cost basis reporting has received detailed focus from the House, Senate tax committees, and Treasury Dept. staffs and is endorsed by their chairs and key officials.
- ✓ Moreover, even if it is delayed, it is likely to be included in future tax bills and enacted into law relatively soon.

Likely Effective Date

- ✓ House bills included staggered effective dates:
 - Stock—Jan. 1, 2009
 - Other securities (debt, certain options)—Jan. 1, 2011
- ✓ President's 2009 Budget provides a single Jan. 1, 2010 effective date
- ✓ All proposed effective dates have been approximately 24 months— *but rounded down to less than 2 years*

Important Details of House passed version

- ✓ Brokers required to report *adjusted basis* information on sale of “covered securities” (“specified securities”--principally, stocks and securities acquired after the applicable effective date)
- ✓ Brokers would need to not only track cost but also corporate actions adjustments
- ✓ Brokers would also need to apply wash sale rule adjustments (under simplified assumptions discussed later) in computing basis and holding period
- ✓ Stocks & debt instruments such as bonds, notes, debentures covered
- ✓ Stocks presumably includes U.S. REIT shares (since U.S. real estate investment trusts are taxed as corporations)
- ✓ No exception for non-U.S. stocks and securities
- ✓ Certain options covered
- ✓ Swaps, currency contracts and other derivatives not covered
- ✓ Short sales covered

Important Details of House passed version-2

- ✓ Brokers would also report long-term & short-term capital gain & loss classification (but not actual holding periods or acquisition/disposition dates)
- ✓ Special rules and transition rule for averaging open-end mutual fund shares
- ✓ If customer transfers portfolio holdings to another broker, transferring broker would have to provide transferee with basis information
- ✓ IRS regulations could require customers to provide brokers with information needed to correctly adjust basis or initial basis if broker has no other way of knowing
- ✓ Issuers of specified securities required to directly provide brokers with corporate action information or to a central repository
- ✓ Deadline for Form 1099-B delivery to customers would be changed from January 31 to February 15 (Treasury study to extend to other 1099s)
- ✓ S corporations would be treated as partnerships subject to Form 1099-B reporting purposes (effective January 1, 2011)

Covered Securities

- ✓ Stock acquired on or after Jan. 1, 2009
- ✓ Notes, bonds, debentures or other evidences of indebtedness acquired on or after Jan. 1, 2011 (or later)
- ✓ Applies to public and privately issued stocks and debt
- ✓ Any commodity or contract or derivative with respect to a commodity if IRS determines basis reporting is appropriate (2011 or later)
- ✓ Any other financial instrument the IRS determines is appropriate (2011 or later)
- ✓ Also includes short sales & certain options (discussed later)
- ✓ Appears to apply to U.S. and non-U.S. issued stock and debt (corporate action, withholding and currency concerns)
- ✓ Debt appears to include mortgage-backed securities (special OID rules)

Basis Method & Pre-Effective Date Fund Shares

- ✓ Generally, FIFO method applies unless customer has adequately identified specific shares (HIFO, and other methods)
- ✓ FIFO and specific ID is applied on an account by account basis
- ✓ Open-end mutual fund shares: broker (on a broker by broker basis) determines method (FIFO, specific ID or permitted average cost methods) for shares acquired before Jan. 1, 2011
- ✓ Open-end mutual fund shares acquired on or after Jan. 1, 2011—broker determines method unless customer notifies broker and elects another method
- ✓ Pre-Jan. 1, 2009 open-end fund shares treated as held in a separate account for basis method computation purposes unless fund elects combining (for a holder)
- ✓ Exchange traded funds are not open-end funds
- ✓ Eligibility and elections for cost basis averaging

Wash Sales

- ✓ Wash sale rule of IRC Sec. 1091 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
- ✓ Brokers were concerned that this test was too hard to apply for cost basis reporting purposes
- ✓ Bill 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)(unless and until IRS issues rules to the contrary)

Short Sales

- ✓ A short sale is the sale of stock on behalf of an investor that is borrowed from a broker on the date of the sale—on a later closing date the investor delivers the borrowed stock to the broker
- ✓ For tax purposes, investors are taxed on short sales when they are closed (unless constructive sale rule of Sec. 1259 is triggered)
- ✓ Inconsistent with tax rule, short sales are currently reported on Form 1099-B in the year of sale (not closing)
- ✓ Bill would generally require short sales proceeds and basis reported in year of closing
- ✓ Except current reporting applies if short sale triggers a constructive sale—this is a complex determination
- ✓ Concerns about the mechanics of this provision

Options

- ✓ If a *covered* security is acquired or delivered due to the exercise of an option and the option and the related covered security are held in the same account, proceeds and basis reporting on the security would need to take into account the option premium paid or received.
- ✓ Reporting would also apply on the lapse or closing of options related to *specified* securities. Proceeds treated as zero for grantee if option lapses.
- ✓ These rules apply to options acquired on or after Jan. 1, 2011
- ✓ Concerns about the mechanics of these rules—have all basic option transaction types been covered and are these rules consistent with existing law

Key Areas of Concern Regarding Proposal

- ✓ Developing software systems to accurately track tax basis
 - Tax lot detail needed due to wash sale and short/long holding period reporting requirements
 - Corporate actions including REIT return of capital adjustments will need to be taken into account
- ✓ Grandfathering & Averaging
 - Bifurcation of accounts into pre-effective date and post-effective date subaccounts—system constraint concerns
 - Averaging rules only available for open-end funds; transition rule and subsequent taxpayer override
- ✓ Mismatch risk
 - Corporate actions with no single answer
 - Reporting for fractional shares
 - Single account wash sales versus cross account wash sale basis adjustments
- ✓ Rapidly approaching effective date

Key Areas of Concern Regarding Proposal-2

- ✓ Tax penalty risks “raise the bar”
 - Both basis reporting and corporate action reporting will be subject to tax penalties applicable to information returns
 - Sec. 6721 imposes a \$50 per return (up to \$250K) for failing to file correct 1099s; Sec. 6722 imposes a separate \$50 per return (up to \$100k) for failing to provide taxpayer with correct 1099s; each penalty is 5% of amount that should have been reported without limit if intentional disregard
- ✓ Corporate actions reporting complexities
 - Some corporate actions have no tax opinion or possible alternative tax treatments
 - Non U.S. stocks and securities routinely have no U.S. tax opinion
 - Generally unclear tax treatment of bankruptcy reorganizations
- ✓ Taxpayer election complexities for basis computations 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)
- ✓ Difficulties in properly reporting short sales—determining whether a constructive sale has occurred

Other Concerns

- ✓ Broker account transfers
 - Data system mechanics and compatibility issues
- ✓ Treatment of basis adjustments for gifts
- ✓ Corporate action reporting by issuers and central repository
 - Issuers will be subject to penalty risk
 - Detail left to be addressed in IRS guidance—when?
 - Will corporate issuer data provided be adequate for broker reporting?
 - How or will central repository be implemented?

Conclusions—Difficult Concerns Remain

- ✓ Basis reporting raises many complexities with little time to prepare and significant penalty risks
- ✓ IRS details will be critical given that the impact of some corporate action events on basis will not be clear
- ✓ Brokers will need to determine whether their data systems do and can provide the necessary information to make adjusted basis calculations for holdings—they will also need to address account transfer requirements
- ✓ Brokers and issuers will need to further scrutinize corporate action events for tax accuracy due to potential Form 1099 penalty risks
- ✓ Both holders and the IRS will need ways to independently verify the accuracy of broker Form 1099 basis reporting or they will be forced to live with whatever brokers provide

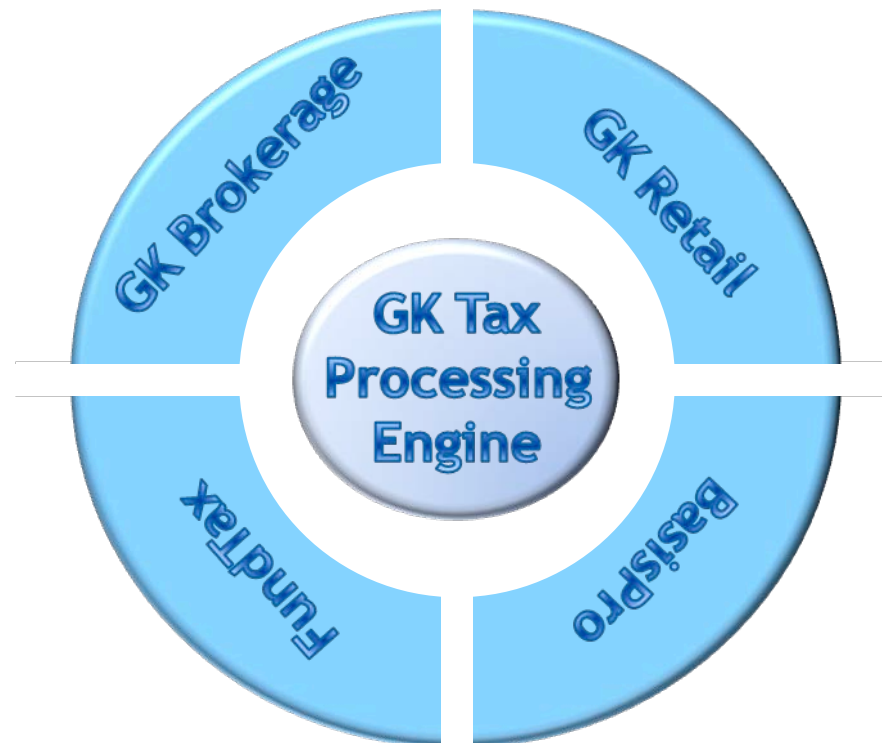
How is the Industry Responding?

√ Many Firms are Preparing Now

- Large # of RFPs
- Build vs. buy evaluation
- Working with clearing firms/software vendors
- Current GK customers expanding usage of system
- New GK implementations under way
 - √ Utilizing Phased Approach
 - Phase 1 - Populate missing cost basis data
 - Phase 2 - Maintain cost basis going forward
 - √ Timeline to fully implement solution can take 3 - 12 months depending upon approach

Wolters Kluwer Cost Basis Solutions

Our Industry-Leading Applications are built on the GainsKeeper Tax-Processing Engine which utilizes CCH corporate actions data.



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