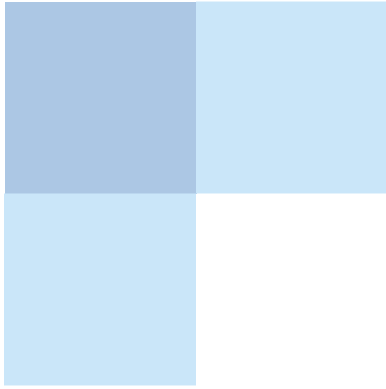

Cost Basis Reporting Legislation: Close to Becoming Law

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In late November and early December 2007, the House of Representatives passed two separate bills (H.R. 3996, the Temporary Tax Relief Act of 2007 and H.R. 6, the Clean Renewable Energy and Conservation Tax Act of 2007) that included cost basis reporting legislation. However, because of other provisions in these bills, they were not passed by the Senate and did not become law last year.

There are significant indications that cost basis reporting legislation is close to becoming law. Its passage by the House late in 2007 is one. Also, it does not appear that the cost basis reporting proposal had anything to do with the Senate's failure to pass the two bills that included it. In fact, it's likely that on its own, the cost basis legislation would have been approved by the Senate. Note that cost basis reporting was originally proposed in the Senate and both the Chairman of the Senate Finance Committee and the ranking Republican on the committee are in favor of the legislation. Another factor is that cost basis reporting is again included in the president's budget for the upcoming fiscal year that was released on February 4, 2008. This suggests that if the cost basis proposal is passed by both the House and Senate, the president will likely sign it and it will become law.

On February 6, 2008, The Wall Street Journal published an article on the cost basis reporting legislation. According to tax policy consultants quoted in the article, "Congress is highly likely to pass a basis-reporting bill this year" and "...it is extremely likely to be included in some tax bill this year." GainsKeeper has been actively tracking the legislation and the view that cost basis reporting is on the cusp of becoming law soon is consistent with our insights—now that the tax stimulus legislation has passed, any tax bill for 2008 will likely include cost basis reporting and its chances of becoming law in 2008 are high.

If a law is passed this year, one troubling aspect is that brokers may have relatively little time to prepare their data systems and information return processing due to the proposed effective date. The cost basis reporting legislation passed by the House would have been effective for stock acquired on or after January 1, 2009 and certain other securities such as bonds, notes and other forms of debts, as well as certain other transactions acquired or occurring two years later (January 1, 2011).

Cost basis reporting legislation would generally require brokers to report to the IRS and taxpayers the adjusted basis of stocks and certain securities (such as bonds, notes, debentures or other evidences of indebtedness, as well as certain other transactions). Cost basis information would be included by modifying the existing Form 1099-B gross proceeds reporting rules. Several bills were previously introduced proposing cost basis reporting and prior GainsKeeper articles—one in March 2007 and another in June 2007—addressed these earlier bills.

Important Details Concerning the Cost Basis Reporting Legislation

The passage of cost basis reporting legislation in late 2007 presents a clear idea of the current state of important details that could have significant consequences to brokers and other parties responsible for producing the information reporting returns that will include cost basis information (Form 1099-B). This section discusses those details.

Brokers would be required to report to the IRS and customers the adjusted cost basis of "covered securities" and whether gain or loss is long-term or short-term on Form 1099-B. This form

currently reports gross proceeds from the sales of certain securities. The broker reporting rules would also require Form 1099-B broker proceeds and basis reporting to S corporations (a special type of corporation under federal tax law) on or after January 1, 2011. The due date for providing Form 1099-B (and related forms for reporting dividends, interest, royalties, etc.) to customers would be pushed back from its current January 31 deadline to February 15.

Covered securities are securities of certain specified types acquired after a specified date. The types of securities are stock (including shares in mutual funds and presumably real estate investment trusts), debt (including any note, bond, debenture or other form of debt), and commodities, derivatives in commodities, or any other financial instrument, if designated by the IRS. Covered securities include stock acquired on or after January 1, 2009 and other covered securities (such as debt) acquired on or after January 1, 2011 or later as designated by the IRS.

Because investors may hold more than one lot of a particular security, brokers must determine the appropriate lot (or lots) in order to compute the adjusted basis of covered securities for reporting purposes. For stock other than open-end mutual fund shares and debt, the basis is determined using the first-in, first-out (FIFO) method unless the customer has adequately identified specific shares (specific ID permits investors to use a variety of methods including highest-in, first-out (HIFO) and other methods). The basis of open-end mutual fund shares would be determined under the FIFO, specific ID, or special average cost methods currently available for mutual fund shares. For open-end mutual fund shares acquired before January 1, 2011, the broker (rather than the customer) determines the method and a customer's methods may vary from broker to broker. On or after January 1, 2011, the broker determines the method unless the customer notifies the broker and elects another permitted method. Exchange traded funds are not open-end funds. For certain multi-class funds, some classes may be treated as open-end fund shares and other classes may not. Basis determinations are made on an account-by-account basis. Pre-January 1, 2009 open-end mutual fund shares are treated as held in a separate account for adjusted basis computation purposes. However, funds can elect, on a holder by holder basis, to treat all stock, including pre-January 1, 2009 acquired stock, as part of the same account.

In order to determine adjusted basis, brokers will be required to take into account adjustments for various types of corporate actions such as stock splits, stock dividends, mergers, spin-offs and others (new Internal Revenue Code Section 6045B). The determination of these adjustments could be complicated and will necessitate detailed tracking of these various events and a determination of their tax significance. The cost basis reporting legislation directs the IRS to issue regulations requiring issuers of various types of covered securities to issue returns or publicly provide the necessary information. Special rules would apply for securities held by nominees. Penalties would apply to issuers that did not properly comply with these new reporting rules.

Because investors transfer their accounts from one broker to another for various reasons, the rules impose reporting obligations on the transferring broker to the receiving broker for covered securities so that the receiving broker can comply with the cost basis reporting rules (new Internal Revenue Code Section 6045A). The IRS can issue regulations imposing these transfer reporting rules on other persons that transfer securities. Penalties are imposed on brokers (or others) that fail to comply with these rules.

Wash sales also potentially affect the adjusted basis of covered securities. A wash sale generally involves the sale of a stock or security at a loss and the acquisition of substantially identical stock or securities within a 61 day period beginning 30 days before the date of sale and 30 days after. The wash sale rule of Internal Revenue Code Section 1091 prevents taxpayers from claiming losses for wash sales and results in basis and holding period adjustments to the substantially identical stock or securities acquired. Accordingly, brokers asked whether they would need to make basis adjustments to account for wash sales under the cost basis reporting legislation. They were concerned because determining whether a wash sale has occurred and calculating the basis and holding period adjustments to acquired stock or securities can be complex. Unfortunately for brokers, the cost basis reporting legislation specifically requires brokers to apply the wash sale rule in computing basis for reporting purposes. However, in order to address brokers concerns regarding potential difficulties in applying the wash sale rule, the cost basis reporting legislation permits brokers to make two key simplifying assumptions: 1. wash sales are calculated only with respect to identical securities (having the same CUSIP number), rather than a broader class of "substantially identical securities" and 2. the wash sale rule is only applied on transactions within a single account, even if a customer has multiple accounts with the same broker (unless and until the IRS issues rules to the contrary).

Special rules apply regarding the reporting of short sales. A short sale generally involves 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 is obligated to deliver the borrowed stock. Short sales are often used by investors to take advantage of expected downward movements in stock prices. For tax purposes, investors are generally taxed on short sales at the time the short sale is closed rather than the earlier date of the sale (assuming the constructive sale rule discussed below is not triggered). Inconsistent with this general tax treatment, short sales are currently reported in the year they are entered into. Under the legislation, short sales related stock basis and gross proceeds would generally be reported in the year the short sale is closed. This new rule would not apply to short sales that trigger a constructive sale under Internal Revenue Code Section 1259 (the year of sale reporting rule would continue to apply to such short sales). However, determining whether a short sale triggers a constructive sale can be complicated. Thus, the exception raises significant complexities and would essentially force brokers to determine in advance whether a constructive sale is triggered by a short sale in order to report it correctly.

There would also be reporting in connection with certain (but not most) option transactions. If a covered security is acquired or delivered due to exercise of an option and the option and the related covered security are held in the same account, gross proceeds and basis reporting would need to take into account the premium received or paid. Reporting would also be required on the lapse or closing of options related to covered securities. These rules would apply to options granted or acquired on or after January 1, 2011.

Conclusion—Significant Complexities Remain with Little Time to Prepare

The cost basis reporting legislation has been through several versions, and the version that passed the House is the most refined to date. Given the attention by the legislative and administration staffs that worked on the details, it is possible there may be only a handful of additional refinements to these rules before they are enacted. Even a simple review of these provisions reveals a number of complexities that brokers, return preparers, tax advisors and taxpayers will

need to consider in implementing and addressing these rules. And, there will be little time to prepare—all of these recent versions of the cost basis reporting legislation provide for very little time before they become effective. For example, the versions passed by the House late last year would have required brokers to track the basis of stock acquired on or after January 1, 2009. Even if the effective date for acquired stock was pushed back until January 1, 2010, that would give brokers and others less than two years to prepare. Thus, it may be imperative to begin planning now in order to be prepared for cost basis reporting once it is enacted.

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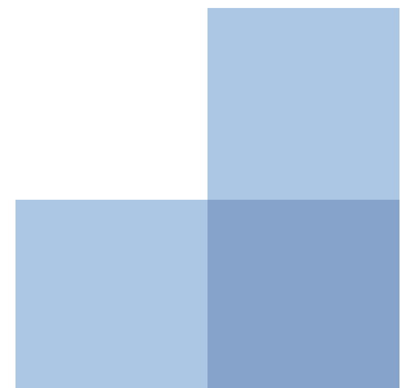

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