

May 13th, 2009 Cost Basis Reporting Webinar
IRS Notice Comments On The Cost Basis Reporting Law: Update For Brokers & Custodians

Q&A RECAP

ABANDONED PROPERTY

Question: How will the cost basis be calculated for securities reported as abandoned property, especially securities found in a safe deposit box where it seems that the cost basis can not be determined?

Answer: The cost basis reporting rules do not specifically address this issue. Note that it may be reasonable to assume that many abandoned securities will be grandfathered (not subject to cost basis reporting) on the presumption that they were acquired before the applicable cost basis reporting effective dates. Comments have been raised regarding stocks that escheat under state law due to abandonment. It is unclear whether or when the IRS will issue specific guidance regarding the determination of basis for abandoned securities for cost basis reporting purposes.

BASIS METHODS

Question: The basis method election is per sale or exchange. A taxpayer may have different methods per different sales. Why is it an issue if the client (taxpayer) changes from average to any other method?

Answer: There are both legal and data system related issues. Legal: Existing IRS regulations governing the election of averaging of cost basis for mutual fund shares do not permit a taxpayer to change or revoke the use of the averaging method once elected (without obtaining written IRS permission, which is generally difficult to obtain). It would not be surprising if the IRS included a similar limitation on averaging for mutual fund and DRIP shares under the amendments to Internal Revenue Code Section 1012 included in the cost basis reporting law. Data systems: As a general matter, once cost information included in tax lots is averaged, it is not necessary to maintain separate tax lot detail (except for holding period purposes) for each of the individual tax lots that are averaged. Elimination of this separate tax lot detail reduces data storage costs. However, if a taxpayer decided to switch from averaging to another lot relief method (such as first-in/first-out or specific ID), the separate tax lot detail would be necessary. Permitting taxpayers to decide to switch out of averaging later would force brokers to maintain this additional tax lot detail, thereby subjecting brokers to additional data storage costs that would otherwise be avoided.

BOND EXCHANGE, OID

Question: Exchange of Bonds -- old bonds for new bonds that include OID, how will the cost basis be calculated?

Answer: The cost basis reporting law does not specifically address this issue. The existing substantive tax rules relating to original issue discount (OID) and the exchange of property for property (such as old bonds for new bonds, whether an actual or deemed exchange occurs) govern the calculation of basis. Although the speakers have extensive experience regarding such matters, the determinations are highly factual and the existing tax rules are complex and beyond the scope of this presentation.

CORPORATE ACTIONS

Question: How to treat corporate actions for which there is no clear taxability and sometimes we do not receive one?

Answer: That's something that we tried to frame in our comment letter precisely for the IRS. Other than with respect to averaging, the cost basis law does not really change substantive tax law. So it doesn't really make the question of whether a corporate action is taxed one way or another any easier for the issuer to answer. So the concern I have is that at some ultimate level unless the tax law changes the rules for mergers that apply to some of the difficult deals that are out there that great tax lawyers in New York and with other prestigious firms address in their tax opinions to the marketplace, there may just not be an answer. What we tried to do in our letter was propose a hierarchy of information that should be reported by issuers to brokers, holders and the IRS. We suggested a "best alternative" approach--tell us what you think the answer would be at a lower standard of diligence/correctness, so we get some answer we can use or give us all the facts so that the broker can use its own corporate action department to come up with an answer.

DRIP DATE

Question: The section 1012 amendment for DRIPs refers to shares purchased after 12/31/2010. How does that date relate to the 1/1/2012 effective date for average basis?

Answer: It seems that the 12/31/2010 effective date for averaging eligibility for DRIP shares could be a drafting glitch that was triggered due to the last minute push-back of effective dates by one year for the cost basis reporting law as enacted versus the one year earlier dates that were included in earlier bills but were not enacted. It is possible that the congressional taxwriters simply missed revising and pushing back by one year to 12/31/2011 the effective date set forth in Internal Revenue Code Section 1012(d)(1). We are not aware of any legislative history that suggests that this one year mismatch was intentional. Unfortunately, unless and until a technical correction to the law is made correcting this error, both the IRS and taxpayers must rely on the effective date as enacted. As the question infers, the difference between the 12/31/2010 effective date for averaging set forth in Section 1012 and the applicable effective date for acquired DRIP shares subject to broker cost basis reporting under Section 6045(g)(3)(C)(ii) of 1/1/2012 is a problem. These mismatched dates could potentially force a broker reporting the basis of DRIP stock acquired during 2012 to take into account DRIP shares purchased during 2011, even though the 2011 DRIP share purchases are not themselves subject to cost basis reporting by the broker. Thus, this mismatch essentially moves up the effective date for DRIP reporting by forcing brokers to develop systems that capture DRIP stock purchase data a year before the reporting effective date begins.

ESTIMATED COST

Question: Do you have any estimates on the cost for complying with the regulation?

Answer: We do not have any specific estimates. However, we note the following: "Based on industry observations, TowerGroup believes ...an internal [cost basis system] build could easily exceed \$5 million in up-front costs. TowerGroup expects ongoing maintenance costs to range from \$500,000 to \$750,000 for a firm with 1 million accounts."

TowerGroup Report "Cost Basis Technology for Broker-Dealers: Build, Buy, or Both?" By Sean Cuniff, January, 2009, Reference #V57:380

ETF RICS IDENTIFICATION FOR AVERAGE COST

Question: The ICI recommended that ETF that were RIC's should also use Average Cost as a disposal method. How can these securities be identified?

Answer: We agree with the ICI that exchange traded funds (ETFs) that qualify as RICs should be eligible for average cost basis determinations. Good point regarding the difficulty in identifying ETFs. ETF status is not readily discernible by CUSIP. We use a table to sort ETFs.

EXTENSIONS?

Question: Stevie, I wonder if you could just expand a bit more. You talked earlier about the Treasury and the IRS regulations, when it might be delivered. If the regulations are not delivered

until 2010, do you think the graduated deadlines will be pushed out further? For example, into January 2011 or January 2012?

Answer: I think there's going to be pressure to do that. I think that, and again, this goes back to my comments earlier about widely held fixed investment trusts. It's a fair comment for someone to say I need the guidance within a certain amount of time, so that I can prepare and particularly if we're talking about tax reporting, much of it is electronic. 1099's are electronically prepared and filed. This involves systems, and systems take time to develop, implement, test, to make sure they work. So, at some point, it becomes unreasonable to ask somebody to get ready too quickly. If you give them three months and they have to upgrade a mainframe system, that's not realistic because software often takes a year or more to develop. The problem that the IRS has is that the new cost basis reporting rules have a hard effective date. The law doesn't say that the IRS can push the deadline back if they're not ready in time. The law contemplates that this provision will raise tax revenue based on compliance beginning in 2011. So I think it's going to be difficult for the IRS and the industry to extend it without some legislative action. I think it's a real concern. That's why the notice came out so early. This doesn't mean the IRS will give guidance that will help us but I think that that's the hope. I can tell you that I think that they are earnestly working hard to do it.

FORM 1099-DIV DATE

Question: Have you heard if Form 1099-DIV's due date has been extended to 2/15/10?

Answer: The IRS issued Notice 2009-11 on January 12, 2009 providing temporary guidance on the extension of the Form 1099-B effective date to February 15th (from January 31st) in the case of "consolidated reporting statements." There is no extension of the January 31st due date for stand-alone Form 1099-DIVs. However, if Form 1099-DIV information is delivered to customers as part of a consolidated reporting statement as defined in Notice 2009-11 (even if a particular statement does not include Form 1099-B gross proceeds information), the consolidated reporting statement is eligible for the newly extended February 15th effective date. The IRS Notice only applies for 2008 Form 1099s. Presumably, IRS regulations or future notices will provide similar rules for future tax years.

HEDGE FUNDS

Question: Would hedge funds and other partnerships be subject to the cost basis regulations?

Answer: Unless the funds or partnerships are brokers subject to Form 1099-B reporting or are considered "applicable persons" for Section 6045A broker transfer reporting, the answer should be no. An earlier Bush Administration proposal would have included certain partnership interests in the class of securities subject to broker basis reporting. However, this version was not enacted into law. Note that the IRS has the power to subject any financial instrument to cost basis reporting if it believes it is appropriate (see Section 6045(g)(3)(iv)).

PUBLICLY TRADED PARTNERSHIP UNITS

Question: How will brokers handle Publicly Traded Partnership Units? Or is this outside the Notice?

Answer: I think we've just covered this one, because most of the hedge funds would be a type of publicly traded partnership. There are other investment partnerships, but I think we've kind of covered this one already. See answer set forth above regarding hedge funds.

UNIT INVESTMENT TRUSTS

Question: Is cost basis reporting applicable to Unit Investment Trusts in addition to the WHFIT reporting regulations?

Answer: It is unclear whether unit investment trusts are also subject to cost basis reporting in addition to WHFIT reporting. As discussed above regarding hedge funds, unless the funds or partnerships are brokers subject to Form 1099-B reporting or are considered "applicable persons"

for Section 6045A broker transfer reporting, the answer should be no. An earlier Bush Administration proposal would have included WHFITs in the class of securities subject to broker basis reporting. However, this version was not enacted into law. Note that the IRS has the power to subject any financial instrument to cost basis reporting if it believes it is appropriate (see Section 6045(g)(3)(iv)).

IRS PREPAREDNESS

Question: No doubt there's a lot of work on the Broker side of the legislation, but is there an impact to the IRS systems in receiving this information from everyone? Are they looking into this themselves? Has Treasury received any comments from any issuer trade association such as TEI regarding their comments on issuer reporting?

Answer: I haven't seen any TEI comments yet and we do track those daily. The IRS has already received comments from IRPAC, the National Association of Enrolled Agents and the AICPA. These comments are posted on the resource page at www.costbasisreporting.com.

LOT RELIEF

Question: Regarding discretionary accounts, does the portfolio manager have control on tax relief/selling method? The concern is that some clients within the same strategy may prefer FIFO, when others prefer high cost/least gain.

Answer: We are anxiously awaiting guidance from the IRS regarding whether the broker or the customer controls lot relief selection. Under current law, the lot relief method is selected by the customer/taxpayer. As noted earlier, the cost basis reporting law does not generally change substantive tax law so presumably the determination will still ultimately be made by the taxpayer.

LOT RELIEF

Question: As an investment manager who actively manages our client accounts, we are just as likely to process a sale FIFO as we would process versus a specific tax lot.

Answer: See answer to prior question.

REPORTING

Question: Should the proceeds figure on the 1099-B reported to the IRS include the market value of new shares received through a cash and stock merger so that the individual's 1040 Schedule D proceeds figure match the 1099-B figure?

Answer: Let me frame this ... I have a customer, they cash in stock, they're taxable, the cash is reported. We have basis reporting. What should happen with the fair market value of the stock component?

Well, presumably the fair market value of the stock component ought to be viewed as additional consideration and presumably the broker ought to report both to the IRS and to the broker's customer that consideration. The customer ought to take a taxable transaction and report that on to the IRS and everything should match. The difficulty goes back to some of the issuer reporting questions, which are how do you deal with what is taxable and what is not? But if you know you have something taxable, then the numbers ought to match up. Assuming that it's a valuation questioning play here, I don't think there's anything in the statute that tells you that the broker's valuation should be controlling as you find in other areas of tax law in which the reported number should be controlling. But I would think that the customer would need some pretty good reason to depart from the taxable proceeds reported to the customer from the broker.

REPORTING: TRANSFER REPORTING

Question: You touched on this briefly, but what are the general thoughts on the responsibility of reporting cost basis between firms? In addition, what transfer mechanisms are firms looking at using (paper, CBRS, other)?

Answer: The timely transfer of detailed cost basis information from one broker to another in connection with the transfer of a customer's securities is essential in order for the holding broker to properly report cost basis when the securities are subsequently sold. This is the reason why the cost basis reporting law included new Code Section 6045A. Unfortunately, this new Code Section leaves the details of transfer reporting to the IRS, and thus, the mechanisms cannot be determined until the IRS issues its guidance. We have submitted extensive comments on transfer reporting.

REPORTING: TRANSFEREE CORPORATE ACTION UPDATE REPORTING RESPONSIBILITY: 'STATUTE OF LIMITATION'

Question: Will brokers have to file corrections if say a corporate action is restated a year or two after the initial 1099 is issued, and will they have to furnish amended transfer statements to transferee brokers?

Answer: This is a great point. Several of the comment letters have raised this issue because of the cost of filing corrected 1099s and the costs of reprocessing all of the basis data in brokers' information systems. Several comment letters have proposed a *de minimis* standard, suggesting that corrections below a to-be-determined level could be ignored.

SHAREHOLDER APPLICABILITY

Question: Who does this requirement apply to: A: Shareholder residing in the US; B: An issuer who is listed on a US Exchange; and/or C: Any others?

Answer: Cost basis reporting applies to any broker currently subject to Form 1099-B reporting. The cost basis reporting law also requires issuer reporting of corporate actions under new Code Section 6045B. One question is whether a foreign issuer of stock must report under the new issuer reporting requirement of Sec. 6045B. A foreign issuer might be outside of U.S. jurisdiction and thus may not be willing to comply with issuer reporting. However, a U.S. depository holding non-U.S. stock could be subjected to penalties and thus forced to provide issuer reporting. Thus, it may be relatively easy to force compliance by issuers listed on U.S. exchanges.

SUBSCRIPTION RIGHTS

Question: Is there a particular guideline for calculating basis on subscription rights?

Answer: This is a great question and one not included in the questions on which the IRS has requested comments. Stock rights can be received by investors for various reasons. If a shareholder receives stock rights from the issuer of the stock, the distribution is generally tax-free under Code Section 305 provided the stock is common rather than preferred. Code Section 307 generally governs the determination of basis of stock rights (and stock) received in tax-free distributions under Section 305. There is a special rule for stock rights providing that if the fair market value of the rights is less than 15% of the fair market value of the related stock at the time of the distribution, then zero basis is allocated to the stock rights and the basis of the related stock is unaffected. However, the holder can elect out of this special rule. If so, the holder's basis in the stock is allocated between the stock rights and the stock based on relative fair market values determined as of the date of distribution. Note that if the stock rights lapse unexercised, the allocated basis reverts to the related stock.

TRANSFER AGENTS

Question: We are an in-house issuer transfer agent - hoping some of today's discussion addresses transfer agent considerations.

Answer: Although we have identified some issues in connection with average cost, there are a number of points that we don't have time to cover. We recommend that you review the excellent comments submitted by The Securities Transfer Association on considerations under the cost

basis reporting law relevant for transfer agents. The comments are on the resource page at www.costbasisreporting.com.

TRANSFER AGENTS

Question: How is cost basis determined for off market transfers submitted directly to a transfer agent by the shareholder? How does this differ if the broker submits the transfer to the TA?

Answer: There are concerns regarding the quality of cost basis information reported by shareholders to brokers or applicable persons under Code Sec. 6045A. The IRS Notice asks questions and solicits comments on transferred information. Comments have been submitted in response from several sources. Also, see answer to prior question.

US/GLOBAL SECURITY APPLICABILITY

Question: What types of securities are subject to this regulation: US securities whether offered in or outside the US market or all securities (including non-US) held by US investors?

Answer: There is no limitation based on whether the securities are offered in or outside the U.S. market or whether the securities are issued by U.S. or non-U.S. issuers. Because there is no limitation, foreign securities are subject to cost basis reporting.

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