



## Web Seminar Q & A Recap

### Preparing For The New Cost Basis Reporting Law:

A practical explanation of the key details that matter to  
brokers & custodians.

November 19, 2008

Copyright 2008 by Wolters Kluwer Financial Services.  
Redistribution without written permission prohibited.

## WASH SALE RULE, MUTUAL FUNDS

**Question:** Does the wash sale rule apply to mutual funds?

**Answer:** Yes. The wash sale rule applies to losses on sales of stock, and mutual fund shares are stock covered by the rule.

## IRS, CORPORATE ACTIONS

**Question:** Does the IRS use Capital Changes Reporter for cost basis allocations for corporate actions?

**Answer:** Yes.

## EXTENDED DUE DATE APPLICATION

**Question:** Is the extended due date to February 15th to provide the Form 1099-B to the client also applied to other 1099 (interest, dividends, etc) when there is a consolidated statement to the client?

**Answer:** Yes. The key issue is whether the statement constitutes a “consolidated statement.” The new law provides that a “consolidated reporting statement” will be defined by the IRS in regulations. These regulations have not yet been published. It is likely that many will attempt to convince the IRS to include their own statements under the definition in order to obtain the extended due date.

## SINGLE, DOUBLE CATEGORY AVERAGING METHODS

**Question:** Do we have to provide both single and double category averaging methods, or can we choose one or the other and offer only the one we select?

**Answer:** Both. The existing regulations permit either method and the mutual fund investor makes the election. Under the new law, the fund will select the method and the customer must elect out if he or she wants to use a different method. The selected or elected method will dictate the basis information reported on Form 1099-B. It is possible that the broker will need to provide both averaging methods in case a customer elects to use either.

## CASH SETTLED OPTIONS

**Question:** Is the 60/40 short/long term capital gains rule going to apply for cash settled options?

**Answer:** This is not a basis reporting question. The application of the 60/40 short/long term capital gain rule under the Code Sec. 1256 mark-to-market system for futures and certain other contracts may already apply to certain cash settled options (even though options are not currently subject to Form 1099 reporting) depending on whether the option is related to stock and whether the option is “broad-based” as defined under Code Sec. 1256.

Cash settled options on specified securities (such as stock and debt instruments) will be subject to Form 1099 gross proceeds and basis reporting under the new law for options granted and acquired on or after January 1, 2013.

## AVERAGE COST METHOD, MUTUAL FUNDS

**Question:** Will there be a requirement to provide average cost method for mutual fund shareholders? Is there such a thing as any methodology requirement under the new law?

**Answer:** Essentially, yes. As discussed above, each individual mutual fund selects the lot relief method for its investors (and this selection can be done on an investor by investor, class by class or other criteria basis selected by the fund). However, each investor can elect out of the method selected and choose another. The right to elect out essentially means that the fund must be able to provide the investor with other methods (FIFO, specific ID and averaging).

## CORPORATE ACTION REPORTING RESPONSIBILITY

**Question:** On some corporate actions, such as spin-offs, the cost basis information is often not immediately available from the companies. It takes weeks sometimes to get the cost information. Whose responsibility is it then if the asset gets sold without the cost information?

**Answer:** It is the broker's responsibility to obtain the cost information and correctly compute adjusted basis. New Code Sec. 6045B obligates issuers of covered securities to file information returns and provide nominees of holders of securities statements setting forth the quantitative effect of a corporate action on basis. However, regardless of whether the statements are timely or even received, the broker's obligation to report adjusted basis remains.

## OPEN LOTS PRIOR TO EFFECTIVE DATE

**Question:** If a client has open tax-lots prior to the effective of the new law (January, 2011), then purchases more of the same security in 2011 and then sells shares in 2011, and the broker calculates 1099 cost based on purchases bought and sold in 2011 but the client does their own reporting to the IRS using cost basis for shares held prior to 2011, does the IRS recognize that there will be this type of reporting differences?

If a client has open tax-lots prior to the effective of the new law (January, 2011), then purchases more of the same security in 2011, then sells shares in 2011, and the broker calculates 1099 cost based on purchases bought and sold in 2011, but the client does their own reporting to the IRS using cost basis for shares held prior to 2011, does the IRS recognize that there will be this type of reporting differences?

**Answer:** The broker must use first-in/first-out (FIFO) unless instructed otherwise by the customer. Hopefully this default method and the customer instruction requirement to use other methods will minimize the type of reconciliation risk outlined.

## FORM 1099 DIV & INT DUE DATE

**Question:** Form 1099 DIV & INT are still due to clients on January 31st right?

**Answer:** Generally, yes. Unless the DIV and INT information is part of a "consolidated reporting statement" (to be defined by future IRS regulations) relating to broker gross proceeds and basis reporting under Form 1099-B (or for substitute payments), the new law does not change the client due date for other types of information returns, such as Form 1099 DIV & INT.

## EFFECTIVE DATES, POSITIONS

**Question:** Do the effective dates apply to new positions established at that time or both existing ones?

**Answer:** Only newly acquired positions. For example, if a customer transfers stock acquired pre-effective date (June 30, 2010) to a new broker post-effective date (March 14, 2011), the position is still a pre-effective date position and is not subject to basis reporting.

## BROKER REPORTING CONSIDERATION

**Question:** Should a broker consider reporting on all positions regardless of the acquisition date, including pre-effective date acquired positions -- rather than maintaining two sets of reporting logic (one for cost basis reporting and one as a customer service)? Do potential penalties for incorrectly reporting cost basis on out-of-scope outweigh the cost of building the reporting logic that will report cost basis for some positions and not others?

**Answer:** Mutual funds and brokers of DRIP shares have the ability to make a single account election and include pre-effective date shares. Under the law, brokers do not have the explicit right to report on pre-effective date shares for regular stock or other types of securities. Including pre-effective date shares, even if permitted, could result in greater penalty risk for incorrect Form 1099s. The significance of this risk likely depends on the broker's historical basis records and specific facts. The analysis of whether the penalties outweigh the cost is fact specific and requires the broker to consult their own tax advisor.

## MUTUAL FUND CALCULATION METHOD SELECTION

**Question:** What is the general consensus for mutual funds regarding which method an account holder wants to use for calculating cost basis if the account exists prior to January 2012?

**Answer:** Many mutual funds are likely to offer only one method or very limited choices to their investors for pre-effective (January 1, 2012) mutual fund shares, due to legacy system and database limitations.

## SHAREHOLDER METHOD CHANGE REQUEST AFTER REPORTING

**Question:** What if the shareholder notifies a broker of a change to a preferred cost basis method after the broker already reported the cost basis to the IRS? For example, if a Broker reported a redemption using average cost method, but the client later states he wanted to use LIFO (last-in/first-out) instead.

**Answer:** Unclear. It is possible future IRS guidance could address this issue. However, there are also two important existing law considerations. First, under current law a taxpayer/client elect average cost by making a designation on Schedule D of his or her tax return the first year the election is to be effective. Once made it is essentially irrevocable without written IRS consent. Second, in order to use a specific ID method such as LIFO, existing law generally provides that the client must provide the broker with instructions regarding the method or lots to be selected that are contemporaneous with the trade. It would appear that the client's request would fail the contemporaneous instruction requirement.

## LOT RELIEF SELECTION: ACCOUNT OR SECURITY LEVEL

**Question:** Can you clarify if the lot relief method selection is required at an account level or at a security level?

**Answer:** Security level. Both lot relief selection provisions of the new cost basis reporting law use the term "any security" or "any stock."

## TAX SEASON 2008—1099 DATE

**Question:** For the 2008 tax season, what is our deadline for issuing a consolidated 1099? January 31 or February 15, 2009?

**Answer:** February 15, 2009 (provided it is either a Form 1099-B or a consolidated reporting statement as to be defined in future IRS regulations).

## WASH SALE BASIS ADJUSTMENT EXAMPLE

**Question:** Can you walk us through a simple example of a wash sales basis adjustment?

**Answer:** Yes. Customer C owns 100 shares of Acme Financial stock acquired at a price of \$5 per share on January 1, 2007. On November 20, 2008, C sells the stock at a price of \$1 per share. C's loss on the sale is \$400 (\$100 proceeds received less basis of \$500). Due to government intervention, the price of Acme's stock rebounds and C purchases another 100 shares of Acme at \$2.25 per share on November 24, 2008. C sells the stock on January 15<sup>th</sup>, 2009 for \$4 a share.

This is a wash sale because substantially identical stock was acquired within the 61 day period beginning 30 days before the date of the sale at a loss and ending 30 days after. The \$400 loss is deferred and is not recognized on C's tax return for calendar 2008. When C sells the stock on January 15<sup>th</sup>, there will be a basis adjustment to account for the prior wash sale deferred loss of \$400. C will incur a loss on the sale on January 15<sup>th</sup> 2009, of \$225 (\$400 of proceeds received less initial basis of \$225 plus \$400 basis adjustment for previously deferred loss). The loss will be long-term because the holding period of the loss shares (acquired on January 1, 2007) will "tack" to the new shares. Note the difference between the book gain on the sale of the new shares of \$175 (as compared to the tax loss of \$225) is exactly \$400—the amount of the deferred wash sale loss.

## DRIP SHARE CALCULATION METHOD

**Question:** What if a shareholder requests another method on DRIP shares than average cost?

**Answer:** Because the customer can elect another method under the new law, it is assumed that the broker will need to provide the shareholder requested method.

## BROKER, CLEARING FIRM RESPONSIBILITY

**Question:** Does this law apply to brokers from the introducing broker-dealer firm/? Or is it more relevant to clearing firms?

**Answer:** It is most relevant to the person deemed a "broker" for cost basis reporting purposes that is obligated to file the Form 1099-B. As a rule of thumb for assessing who is the reporting broker, consider who currently provides the existing Form 1099-B. It is also relevant to a much broader group of financial market participants. For example, persons other than brokers may be obligated to provide brokers with basis information in connection with account and securities transfers under the new law. Issuers of securities will need to file the new corporate action returns and provide the related statements to holders. As customers receive the new basis information, they are likely to ask their brokers basis related questions and those brokers may need the information to respond as a customer service/retention matter.

## FOREIGN SECURITIES

**Question:** Are foreign securities part of this new reporting law?

**Answer:** Presumably, yes. There is no exception from the definition of stock subject to basis reporting for stock issued by non-U.S. entities.

DISCLAIMER: The questions set forth above are general in nature and are not intended as legal, tax, or professional advice. Although based on the law and information available as of the date hereof, general assumptions have been made by GainsKeeper® which may not take into account potentially important considerations to specific taxpayers. Therefore, the questions presented above may not be appropriate for you. Readers must also independently analyze and consider the consequences of subsequent developments and/or other events. Readers must always make their own determinations in light of their specific circumstances.