

Understanding the Final Cost Basis Regulations

Essential Details About the Impact on Brokers and Custodians

Stevie D. Conlon, Steven M. Rosenthal & Dale Collinson

November 10, 2010



About the Speakers

- *Stevie D. Conlon* is Senior Director & Tax Counsel for Securities Tax Solutions, Wolters Kluwer Financial Services. Stevie oversees tax regulatory compliance and strategies for its GainsKeeper, Capital Changes & Basis Pro products.
- *Steven M. Rosenthal* is a Tax Partner in the Washington D.C. office of the law firm Ropes & Gray LLP. Steve advises banks, brokers, mutual funds and other financial institutions on a range of issues relating to financial products and markets.
- *Dale Collinson* is a Director, Financial Institutions and Products, in the Washington National Tax office of KPMG. Dale advises banks, brokers, mutual funds and other financial institutions on a range of issues relating to financial products and markets.

Agenda

- Overview
- Stevie's Top Ten Issues Impacting Brokers & Custodians
- Effective Dates—No Delay
- Transfer reporting penalty relief for 2010: Notice 2010-67
- New Higher Tax Penalties & Intentional Disregard Penalty Risk
- Issues with Covered Securities
- Issues with Lot Relief and Averaging
- Issues with Required Basis Adjustments
- Issues with Transfer Reporting
- Other Items of Interest
- Review
- Questions & Answers

Overview of Cost Basis Law

- Included as part of H.R. 1424, the Emergency Economic Stabilization Act of 2008 (EESA), enacted in response to the financial market crisis on Oct. 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
- Technical corrections proposed in Dec. 2009
- Proposed Regs issued Dec. 16th 2009
- Only cover stocks, mutual fund & DRIP (DRP) shares (debt & options Regs will be issued later)
- Final Regs issued on Oct 12th 2010 (published Oct 18 in Fed. Reg.)
- No delay of effective dates in Final Regs
- Notice 2010-67 issued with Final Regs—provides penalty relief for not providing transfer statements for stock transfers during 2011 unless transfer was incidental to purchase or sale

Overview: Key Cost Basis Reporting Obligations

- Applies to covered securities—such as stock acquired on or after Jan. 1, 2011 and mutual fund and dividend reinvestment plan (DRP) shares acquired on or after Jan. 1, 2012
- Cost basis must be adjusted for corporate actions and wash sales
- Short-term/long-term gain/loss must be calculated (holding period—which can be affected by corporate actions and wash sales)
- Determining the lot sold (lot relief method) or averaging basis must be done in accordance with strict rules

Stevie's Top Ten Issues Impacting Brokers

1. No effective date delays
2. Limited transfer relief for transfers in 2011
3. No relief from most rules in the proposed regulations
4. No lot selection after settlement date (cutoff)
5. Holding period required instead of "holding date"
6. No wash sales for mark-to-market Sec. 475 accounts
7. Only short sales opened after 2010 reported on close
8. 3 year and 18 month cutoffs for corrected 1099-B's and transfer statements (but no cutoff for issuer statements)
9. Stock transferred to DRP in 2011 becomes noncovered
10. Sorting DRP and non-DRP shares in the same account

Effective Dates—No Delays

- The Final Regs do not change any of the effective dates
- Brokers must report cost basis for covered securities beginning with Form 1099-Bs delivered in Feb. 2012
- Issuers must report corporate actions for specified securities beginning with corporate actions occurring on or after Jan. 1, 2011
- Transfer agents must report transfers of covered securities as early as Jan. 16 2011 (15 days after a Jan. 1 purchase & transfer)—but see penalty relief & Notice 2010-67
- General effective date of Final Regs—tax years beginning after Oct. 18, 2010—this impacts lot relief (1.1012-1)

Effective Dates—Chance of Penalty Relief

- IRS had received extensive comments that it would take time to program computer systems and implement cost basis related procedures
- IRS did not believe it had the power to change the effective dates that had been enacted
- The preamble to the Final Regs provides:
“Additionally, the IRS will continue to work closely with stakeholders to ensure the smooth implementation of the provisions in these regulations, including the mitigation of penalties in the early stages of implementation for all but particularly egregious cases.”
- Penalty relief unclear

Limited Scope of Transfer Reporting Relief

Notice 2010-67

- “In order to promote industry readiness to comply with the reporting requirements for the sale of covered securities under section 6045(g) beginning in 2011, the Service will not assert penalties under section 6722 for a failure to furnish a transfer statement under section 6045A for any transfer of stock in 2011 that is not incidental to the stock’s purchase or sale as described in Treas. Reg. §1.6045A-1(a)(1)(ii).”
- “Further, a receiving broker may treat this stock as a noncovered security.”

Analysis of Notice 2010-67

- Brokers and transfer agents can generally delay transfer reporting until 2012 (reporting transfers of covered securities beginning in that year)
- A transfer agent that is also a broker will need to compute basis adjustments for covered securities acquired during 2011 (no delay for broker reporting)
- Penalty relief does not apply to transfers incidental to purchase or sale transactions—focus on this exception—a transfer agent may need a system for 2011
- Noncovered security status of 2011 transfers should be at discretion of receiver (even if transfer statement is delivered) due to “may” in Notice text.

Significantly Higher Tax Penalties

- Small Business Jobs Act of 2010 (P.L. No. 111-240) enacted on Sept. 27, 2010
- Increases penalty for incorrect or nondelivered 1099s from \$50 to \$100
- Increases penalty for incorrect or nondelivered payee stmts (including transfer statements) from \$50 to \$100
- Increases maximum annual aggregate penalty from \$250,000 (for 1099s) and \$100,000 (payee stmts) to \$1,500,000 each (\$3m total)
- Increases intentional disregard minimum penalties from \$100 to \$250 per return
- New penalties effective for returns and statements filed on or after Jan. 1, 2011

Intentional Disregard Penalty Risk

- *Bale Chevrolet Co. v. US*, 2010 U.S. App. LEXIS 18335 (8th Cir., Sept. 2, 2010), raises concerns that the IRS could sustain significant intentional disregard penalties if a person obligated to provide information reporting to the IRS or holders does not remedy reporting systems deficiencies.
- Intentional Disregard is greater of \$500 or 10% of amount that should be reported without any maximum limit (aggregate of Sec. 6721 and 6722 penalties)

Important Changes Regarding Covered Securities

1. Clarifies REIT shares, foreign stock and ADRs are treated as stock
2. Clarifies that exchange traded fund (ETF) shares treated as stock are covered
3. If the issuer has not classified a security as stock but a broker knows it is stock, broker must treat it as stock for covered securities purposes based on actual knowledge by broker and not a "reason to know" standard (unlike proposed regs). A broker is not bound by another broker's classification of a security as stock.
4. Clarifies treatment of securities received in a corporate action as covered securities unless basis carried over from noncovered securities.
5. Stock received thru exercise of stock option or issuer rights is covered because it is acquired in a sales transaction for cash
6. Stock received in an employee grant is not covered because it is not acquired for cash
7. Stock acquired in 2011 is no longer a covered security if transferred to a DRP during 2011
8. Security acquired for the account of a foreign person is not a covered security unless broker knows or should have known (per Sec. 1471 or 1472) that customer was not a foreign person at time security was acquired
9. Stock sold by a domestic partnership is subject to basis reporting
10. Stock sold by a foreign partnership is exempt from basis reporting to US partners

Important Changes for Lot Relief & Averaging

1. Settlement date selection cutoff retained
2. Taxpayer can authorize an agent to pick lots & method
3. Written confirmation could be a monthly statement
4. 10% minimum dividend reinvestment for DRP retained
5. DRP stock remains identical to same CUSIP stock except while averaging
6. Intra-day averaging if single confirm unless investor elects out
7. Investors failure to notify broker of a lot method is not an election of a method
8. Lot selection is not a method of accounting and changing is not a change of method
9. If averaging is broker default method, taxpayer's method change is prospective
10. Averaging election could cover multiple securities in multiple accounts

Other Lot Relief & Averaging Items

- Deplete shares with unknown acquisition or purchase date first;
- DRP reinvestment includes distributions that are not dividends; transition rule effective date from double category extended to April 1, 2011;
- Investor's election can be electronic; separate acct. rule for DRP & RIC stock acquired before Jan. 1, 2012 eliminated;
- Single account election only applies to accounts with same ownership (*e.g.*, sole versus joint) and only to stock for which broker has accurate basis information;
- Revocation of averaging voids the single account election;
- Confusion on account by account rule application of FIFO

Important Changes to Required Basis Adjustments

1. Holding period, not holding date is required
2. No wash sales if investor informed broker that account is mark-to-market
3. Basis of mutual fund shares must be adjusted for “loads” under Sec. 852(f)
4. Basis must be adjusted for undistributed mutual fund & REIT capital gains reported on Forms 2438 and 2439
5. Short sale rules of Sec. 1233(b)(1) & 1233(d) apply in determining whether gain or loss is long or short-term
6. Optional adj. across accounts, substantially identical wash sales, straddles, constructive sales permitted
7. Sec. 852(b)(4) or 857(b)(8) adj. for long-term capital gain & exempt interest dividends not required
8. Minority shareholder presumption for corporate action adj.
9. 3 year cutoff for correcting Form 1099-B
10. Adjustments for transfer taxes in gross proceeds permitted

Other Required Basis Adjustments

- Currency translation spot rate for transactions converted to US dollars is determined on payment receipt date
- Payment date deemed settlement date for established market
- No wash sale *de minimis* rule
- No computation of wash sales across stock and dividend reinvestment plan (DRP) identical stock that is subject to an averaging election or across covered and noncovered identical stock
- No wash sales or related basis adjustments for previously transferred securities if identical securities are subsequently sold at a loss within the 61 day wash sale period

Important Changes to Transfer Reporting Rules

1. Transfer reporting exemption relating to securities held by and accounts of foreign persons and exempt recipients (such as C corporations, employee plans and IRAs).
2. Exemption for securities lending for broker as principal and no basis reported on lent or borrowed shares transferred for short sales.
3. Elimination of an issuer generated corporate action ID and the obligation to include it on transfer statements.
4. Reduction in number of attributes passed thru & obfuscate personal data
5. Transferors must determine fair market value of securities transferred on inheritance if readily ascertainable (unless authorized representative has provided values)—no obligation to contact authorized representative.
6. 18 month cutoff for updating transfer statements
7. No wash sale de minimis rule
8. Transferor must update for pre-transfer corporate actions
9. Receiving broker must still review and contact transferor if incomplete
10. Gift transfer determination, fair market value and gift date attributes on transfer and gift loss limitation applied by broker retained.

Other Items of Interest

- S corp. reporting and very limited “eyeball” test
- Ineligibility for averaging if DRP permits reinvestment of less than 10% of dividends:
“any written plan, arrangement, or program under which at least 10 percent of every dividend (within the meaning of section 316) on any share of stock is reinvested in stock identical to the stock on which the dividend is paid. ” - key terms- “under which/at least”
- If DRP does not qualify—are all shares in plan non-DRP and covered securities in 2011 instead of 2012?
- Providing all lot relief methods to customers

Review

- Unchanged effective dates put continued pressure on brokers to complete preparations
- Higher penalties creates greater downside risk and puts greater emphasis on tax accuracy in computations
- Holding period, change in inheritance transfer valuation to broker obligation, retained gift transfer rules and Sec. 1015 loss limitation requirement for brokers, 10% minimum DRP reinvestment req't; temporary segregation of DRP shares for lot relief only while averaging and other averaging details create significant additional development and procedures burdens on brokers and custodians

Considerations

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