

Cost Basis Methods, Wash Sales, Short Sales, and Account Transfers

Methods for Calculating Basis and Selecting Tax Lots

The two ways in which the basis of a security can be calculated under the new regulations are Actual Cost and Average Cost. The Actual Cost Method uses the actual basis of each tax lot plus any transactional impacts on the individual lot (i.e. commissions, corporate actions, etc.). The Actual Cost method can be applied to any type of security. The Average Cost method uses the average basis of all tax lots of identical shares of stock (the same CUSIP), and is also adjusted for any transactional impacts. The use of the Average Cost method is limited to mutual fund shares, RIC stock, and shares acquired in connection with a dividend reinvestment plan (DRiP). It's important to note that while the new regulations do not change any existing rules on how cost basis is calculated they do extend the use of Average Cost to DRiP shares, as current law only permits this method for mutual fund shares.

Every custodian and broker is required to maintain a default method for lot relief and alert their customers to which method they are using. The default lot relief method TD Ameritrade uses for all equities is First-In, First-Out (FIFO). You will be given a choice to set the default method for your clients' accounts. This default may be FIFO, LIFO (Last-In, First-Out), High Cost, or Low Cost. However, even if you select FIFO, the new regulations provide that changes can be made on any trade that is executed up to settlement date. Therefore you have the option of choosing one of the other default selections available, or you can also chose to specifically identify the shares to be sold on a lot by lot basis. When calculating cost basis using the Average Cost method, Specific Identification of tax lots is not permitted and the FIFO method of lot relief must be used.

Wash Sales

As you know, a wash sale occurs when a security is sold at a loss and, within a period of 30 days before or 30 days after the sale, the identical (or a "substantially identical") security is purchased. Under these circumstances, that loss will be "disallowed" and may not be considered in calculating your client's losses for income tax purposes. Wash sales with "substantially identical" securities include transactions such as options or convertible securities matched with the underlying stock. However, the new cost basis regulations require that TD Ameritrade only report wash sales on "covered" securities, and then only if both the purchase and sale of those securities occur within the same account with identical securities (same CUSIP number). This means that if your client has more than one account and/or purchases substantially similar securities, the information we are reporting to the IRS will not be sufficient for preparation of their taxes.

All of your clients' trades remain subject to the wash sale rules, regardless of the accounts in which the transactions were performed. Your clients should understand that this requirement applies to managed accounts, self-directed accounts and even IRAs. Therefore, it is important to note that wash sale information on the 1099-B reported by us may not match your clients' final Schedule D forms when dealing with multiple accounts. In this case, your clients will

have to track their wash sales and recalculate the 1099-B information they are provided from us (or from another custodian) to arrive at the proper filing information for Schedule D purposes.

You should also be aware that the new 1099-B will include cost basis information in the aggregate, if more than one tax lot was used in a transaction. Having access to lot specific information on wash sales and on securities you will have to merge into the reported wash sale strings will be critical to enabling your clients to reconstruct their real wash sale activity. The supplemental statement we will be furnishing for your clients' annual activity will include detailed lot information for every trade.

An additional 1099-B challenge arises for your client as a taxpayer when information previously reported on a 1099-B has been recalculated and a new form must be reissued. This could give rise to refiling a tax return. Under the new regulations the obligation to reissue a 1099-B is for any dollar amount changes (there is no de minimis exemption) and this obligation remains open indefinitely (there is no cutoff in time).

As a result of these complexities, we recommend that you review your portfolio accounting software capabilities and make certain it is up to the task to assist your clients in dealing with wash sales. Overall, we urge that you be vigilant and communicate with your clients to uncover any discrepancies that could exist in their accounts. We will do our utmost to exercise care in processing your clients' securities transactions and maintaining the accuracy of their accounts.

Under the new cost basis regulations, TD Ameritrade will be reporting to the IRS the amount of disallowed loss on the 1099-B issued for that sale. In addition, we must take into account the previous amount of disallowed loss in determining the adjusted basis of the replacement securities when reporting the eventual sale of the security.

Short Sales

Under the previous regulations, gross proceeds reporting standards required custodians to report in the year in which a short sale obligation was opened. Now, basis and proceeds for covered securities will be calculated and reported when short sale obligations are closed. Due to the change in timing of short sale reporting, the new regulations provide for a transition period to begin in 2010. All short sales opened and closed in 2010 will be reported on a 1099-B as always at year end. Consistent with reporting procedures for short sales opened on or after January 1, 2011, they will be reported upon for the year end in which they are closed. If covered securities are used to close the transaction the basis information of the short sale will also be included. If non-covered securities are used to close the sale, then only the proceeds will be reported on the 1099-B regardless of what year it is closed.

When transferring an account with short sale positions, the new regulations provide that if the short sale is closed out with borrowed securities on the books of the broker delivering out the account, then the receiving broker will be responsible for issuing the 1099-B when the short sale is closed. The delivering broker will be required to furnish sufficient information to the receiving broker so that the receiving broker can issue the 1099-B at the time of closing the short sale. This is one of many matters that you should concern yourself with when a client's account moves from custodian to custodian.

Assisting a Client Transferring an Account

There is a new Transfer Statement that is required to accompany all transfers of securities between brokerage firms, custodians and other financial services organizations. Any securities that your clients transfer from one account to another will be impacted by this. This requirement will be phased in effective January 1, 2011 in a manner similar to covered securities. However, all specified securities in that class, whether covered or not, are required to be accompanied with a transfer statement. So as of January 1, 2011 all transferred equities, except those participating in a DRiP at the time of their acquisition, must be accompanied by a Transfer Statement within 15 days of the transfer. This includes equities held in accounts exempt from 1099-B reporting, such as IRAs and institutional accounts, as well as equities that were acquired prior to the applicable date in a reporting account.

Transfer statements for non-covered securities will not require basis information, but rather will require the date the transfer statement is being furnished, the name of the broker or custodian effecting the transfer, the name of the broker or custodian receiving custody, information on the beneficial owner prior to and after the transfer, information on the securities being transferred, and the transfer dates. The information required to accompany covered securities includes all of the above, as well as additional information about the adjusted basis of the securities by lot, original acquisition dates, and dates for computing long- or short-term gains or losses. There are also specific additional information required for gift transfers and inheritances.

If the covered securities being transferred are a gift, the transfer statement must indicate the transfer is a gift, the date of the gift and the market value on that date (The date of gift and market value will be the date the transfer occurs at TD Ameritrade). The proposed regulations provide a special reporting rule for brokers that applies to the sale of a gifted security when the security's adjusted basis depends upon its fair market value as of the date of the gift but the transfer statement received by the selling broker does not report this amount and this amount is not readily ascertainable by the broker. Under these circumstances, the proposed regulations provide that the broker must report adjusted basis equal to the gross proceeds from the sale.

Much of the legislation addresses how securities are to be transferred in order to preserve the integrity of information on covered securities. If proper information does not accompany the securities they will become non-covered and subsequent complications to tracking basis could occur. For partial transfers, securities are transferred on a FIFO basis unless instructed otherwise. Specific lot selection on a transfer can be made up until the day the transfer settles.

As an RIA, it will be beneficial to pay attention to the default method if the new custodian uses a different method for lot selection than the prior custodian. You should also pay close attention if the receiving custodian uses a different cost basis engine, or if the receiving custodian is structured to support customer cost basis needs differently. Making certain a client's transferred securities are handled properly and timely will avoid issues for the custodian, the portfolio accounting system and, ultimately, for you and your clients. Information received from the delivery custodian for covered securities will be considered as the cost basis going

forward. If there are discrepancies with that data, the client will need to work with the delivering firm to have it updated. It would be prudent for you and your clients to ensure that all information has been transferred successfully, so that your client can avoid complications when it comes time to fill out Schedule D forms.