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Tax Update

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New Cost Basis Reporting Rules (Form 1099-B) Effective For 2011

by Ron Kramer, Director of Strategic Tax Planning

If your memory is as bad as mine, you have probably forgotten that certain provisions included in the Emergency Economic Stabilization Act of 2008 (October 2008) will require securities brokers and certain issuers of securities to provide more information concerning cost basis in securities transactions beginning in 2011. These new rules were enacted as revenue raisers to pay for the tax incentives contained in the Act. In what seems to be more "big brother" legislation, the new cost basis rules are designed to:

- Reduce the tax gap on the current reporting of capital gains and losses.
- Simplify basis reporting for investors by making brokers serve as third-party record-keepers.
- Increase voluntary compliance of taxpayers by forcing them to correctly report the tax basis of assets sold.
- Facilitate IRS enforcement by way of a Form 1099-B matching program.

The 2008 Act provides new rules for reporting and tracking a taxpayer's cost basis and holding period in three areas.

1. Broker Reporting of Customer's Basis in Securities Transactions.

Beginning on January 1, 2011, securities brokers are required to report to the Internal Revenue Service (IRS) a customer's adjusted cost basis for securities sold and to classify any gain or loss on the sale as long-term or short-term. These new reporting rules are being phased-in over a three-year period, starting with securities acquired on or after January 1, 2011.

2. New Rules for Securities Transfers (Broker-to-Broker Reporting).

Starting in 2011, a broker or other transferor of securities must provide a "transfer statement" to the broker receiving the securities. If the security is a covered security, the transfer statement will include the security's adjusted basis and acquisition date. The receiving broker will use the transfer statement information to accurately report the customer's cost basis upon a later sale of the securities to satisfy the basis and holding period reporting requirements described in (1) above.

3. Information on Corporate Actions Affecting Cost Basis.

Starting in 2011, securities issuers are required to provide information to the IRS and to holders on the effect on cost basis of corporate actions, such as a stock dividend, stock split, reorganization, redemption, stock conversion, recapitalization, corporate division or similar actions. The required information must set forth a description of the organizational action and the quantitative effect on the basis of the specified security.

The specifics of each of the new cost basis reporting rules are discussed below.

Broker Reporting of Customer Securities Transactions

Introduction

The 2008 Act added Section 6045(g) to the Internal Revenue Code (IRC). IRC Section 6045(g) provides for additional information required in the returns from brokers (i.e., Form 1099-B) in cases of securities transactions with customers. Specifically, IRC Section 6045(g) requires brokers to report to the IRS their customer's adjusted cost basis for securities sold and to classify any gain or loss on the transaction as long-term or short-term.

The new reporting rules are being phased-in over a three-year period starting with securities acquired on or after January 1, 2011. Since the new reporting rules are a major undertaking, the law under IRC Section 6045(g) provides for a three-stage phase-in of cost basis reporting. The phase-in is based on the type of security and the year it is acquired. The applicable dates and securities subject to the phase-in are as follows:

- Any share of stock in a corporation acquired on or after January 1, 2011.
- Mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012.
- Other specified securities (bonds, options, commodity derivatives and other financial instruments identified by the Treasury Department) acquired on or after January 1, 2013.

Thus, securities acquired before 2011 are exempt from basis reporting.

Regulations

The IRS released proposed regulations on broker reporting of securities sales and on the basis of securities in December 2009. The proposed regulations were followed by final regulations in October 2010. These regulations affect brokers and custodians that make sales or transfer securities on behalf of customers, issuers of securities, and taxpayers that purchase or sell securities. Rules for how brokers must calculate cost basis, determine the holding period, identify securities sold and how they transfer cost basis information when securities are moved from one account to another are contained in the regulations.
The law and regulations regarding a broker's reporting of customer transactions is discussed below.

Covered Security

The regulations use the term "covered security" to describe a security for which basis reporting is required. Both domestic and foreign securities are included. A covered security is:

1. A security acquired in an account for cash after its applicable date (for example, stock acquired in 2011).
2. A security transferred to an account from an account in which it was a covered security and for which the transfer statement indicates it is a covered security.

The regulations also treat as a covered security a security acquired due to a corporate action such as a stock dividend, stock split, reorganization, redemption, stock conversion, recapitalization, corporate division or similar action if the basis of the new security is determined from the basis of a covered security. Securities that are not covered securities are exempt from basis reporting. The regulations list the following as not-covered securities (i.e., noncovered securities):

1. A security acquired prior to 2011.
2. A security acquired due to a corporate action where the basis is determined from the basis of a noncovered security.
3. A security acquired in an account that is exempt from Form 1099-B reporting at the time of acquisition, (such as tax-exempt accounts, IRA and other retirement accounts, corporate accounts (other than S corporations) and accounts of nonresident alien).
4. A transferred security where the transfer information indicates it is a noncovered security, the transfer information is incomplete, or no transfer information is provided.

S Corporations Are Subject to Basis Reporting in 2012

Under current law, brokers are not required to report sales of securities by corporations, including S corporations. The new basis reporting rules require brokers to begin Form 1099-B reporting for S corporations for sales of covered securities acquired by the S corporation on or after January 1, 2012.

A corporation will be presumed to be an S corporation unless a broker receives a new Form W-9 stating that the customer is not an S corporation.

> *Comment: Some brokerage firms may be requesting a new Form W-9 from all corporate clients during 2011 to clarify continued exemptions for regular C corporations. However, you may wish to be proactive and file a new Form W-9 with your broker to assure your continued exemption from 1099-B reporting.*

Tax Year for Reporting Short Sales

For 2010 and prior years, proceeds from short sales were reported on Form 1099-B for the year in which the short position was opened. Starting in 2011, a short sale is reported on Form 1099-B in the year the short position is closed rather than in the year the short position is opened. Thus, the cost basis regulations have changed the timing of reporting for short sales to match the year in which customers have to report short sales on their tax returns. If covered securities are used to close the short sale, Form 1099-B will also report the adjusted cost basis and whether any gain or loss is long-term or short-term. Adjusted cost basis will not be reported if noncovered securities are used to close the short sale and the broker indicates on Form 1099-B that the short sale was closed by delivery of a noncovered security. The broker must report the date on which the short sale was closed in lieu of date the shorted stock was sold.

Brokers Must Report Wash Sales

Starting in 2011, brokers must take into account the effect of wash sales in computing cost basis and holding period for covered securities. A wash sale occurs when stock or other securities are sold at a loss (but not a gain) and within 30 calendar days before or after the day of the sale (trade date) on which the taxpayer repurchases the same security or a “substantially identical” security. If a wash sale occurs, the loss on the sale is deferred until the repurchased security is subsequently sold. The wash sale loss is added to the basis of the replacement securities to preserve the benefit of the disallowed loss. Also, the holding period of the replacement securities is adjusted. A separate box on Form 1099-B will report the amount of the disallowed loss on a wash sale. Brokers are required to report wash sales only when:

1. The sale and repurchase both take place within the same account.
2. The securities sold and the repurchased securities are identical, meaning that they have the same Committee on Uniform Security Identification Procedures (CUSIP) number.
3. Both the securities sold and the repurchased securities are covered securities.

> *Comment: If taxpayers conduct wash sales in different accounts, they cannot rely entirely on brokers' statements to correctly report wash sales in their tax returns.*

Identification of Securities Sold

There are three methods of identifying the cost basis of securities sold allowed under the Internal Revenue Code, and brokers are required to report the basis of securities sold based on the tax lot identification method selected by the customer. The three methods of cost identification allowed under the Internal Revenue Code are:

- First in, first out (FIFO basis)
- Specific identification
- Average cost basis

First-In, First-Out (FIFO)

The FIFO method is the default method and applies to stocks, bonds and mutual funds. Brokers are required to report the sales of securities on a FIFO basis if no other method is chosen by the customer. Under FIFO, the first shares purchased are assumed to be the first shares sold. The new rules require that shares with an unknown or missing acquisition date are treated as the earliest shares purchased.

> *Comment: The FIFO method is the simplest method to use for tax purposes but may create the largest amount of income to be taxed, since the longer you own a stock, the bigger your capital gain is likely to be.*

Specific Identification

Customers can identify to their broker the specific stocks, bonds and mutual funds to be sold. This identification must be made at time of sale, but no later than settlement date. The broker is then required to provide a confirmation that the specific shares were sold. Brokers are prohibited from changing lots at a later date.

> *Comment: The specific identification method requires the largest amount of record keeping, but allows you to manage the amount of income tax owed by identifying the specific shares that may be most beneficial to sell from a tax point of view.*

Average Basis

Average basis is determined by averaging the basis of all shares of identical stock in an account regardless of holding period. The basis of each share of identical stock in the account is the aggregate basis of all shares of that stock in the account divided by the aggregate number of shares.

Prior to 2012, use of the average method is allowed only for the owner of mutual fund shares. Starting in 2012, brokers are required to allow customers to elect the use of the average basis method for mutual fund and Dividend Reinvestment Plan (DRIP) shares.

When average basis shares are sold, the first shares purchased are assumed to be the first shares sold. Thus, the first shares sold are those with a holding period of more than one year (long-term shares), if any. If the number of shares sold exceeds the number of long-term shares, the excess shares sold are deemed to be shares with a holding period of one year or less (short-term shares).

> *Comment: As might be expected, use of the average basis method generally results in a moderate amount of gain and income tax. Brokers will likely be informing customers on how to elect to use the average basis method for 2012 later this year. You should only elect the average basis method if it gives you a better result than the regular rules discussed above.*

Average Basis Method Changes

The final regulations simplify changes to and from the average basis method for mutual fund and dividend reinvestment plan shares. The proposed regulations had provided that such an alteration would, under some circumstances, be a change in a method of accounting requiring the Commissioner's consent. Under the final regulations, a taxpayer can elect into or out of averaging at any time on a prospective basis. In addition, a taxpayer who elects into averaging can revoke that election before the first sale of stock subject to the election (but no later than a year after the election, unless the broker permits a longer time). A revocation restores the separate basis of the shares that were subject to the election.

New Rules for Securities Transfers

Beginning in 2011, a broker or other transferor of securities must provide a "transfer statement" to the broker receiving the securities. The transfer statement will identify whether the security being transferred is a covered or noncovered, security and, if the security is a covered security, the transfer statement will include the security's adjusted basis and its original acquisition date. The transfer statement must be furnished within 15 days after the date of settlement for the transfer.

The receiving broker uses the transfer statement information to report the customer's cost basis upon a later sale of the securities. The receiving broker may treat the security as noncovered and not subject to basis reporting if a transfer statement is not provided or is incomplete.

> *Comment: If you initiate a transfer of your security accounts between brokers, you should review the cost basis, acquisition date and any other information relating to the transferred securities to be certain of its accuracy in the hands of the new broker.*

Gifted and Inherited Securities

The new rules for security transfers also apply to gifted and inherited securities. If you transfer securities beginning in 2011, your broker will likely ask if the securities being transferred are the result of a gift or inheritance. This is because the new cost basis regulations require that covered securities being transferred, as a gift or inheritance, be marked as gifted or inherited on a transfer statement and also in the account that receives the securities, in order for brokers to apply the special basis adjustment rules for gifted and inherited securities.

Gift Transfers

When covered securities are transferred to a different owner as a gift, the transfer statement must indicate that the transfer is a gift and must report the donor's adjusted basis and the donor's original acquisition date. In addition, the transfer statement must report the date of the gift and the fair market value of the security on the date of the gift.

> *Comment: The regulations create the presumption that a transfer of a covered security to a different owner is a gift if the reason for the transfer is not known. Your broker will likely be asking you to tell him or her if a transfer is a gift or not a gift at the time of transfer.*

Basis Rules for Gifts

If the fair market value of the gift security on the date of the gift is less than the donor's adjusted basis, the donee's basis on a subsequent disposition of the security will depend on whether the donee realizes a gain or a loss. If the donee realizes a gain, the donee's basis (the gain basis) is the donor's adjusted basis. If the donee realizes a loss, the donee's basis (the loss basis) is the fair market value of the security at the time of the gift. The effect of this special loss basis rule is to preclude the shifting of a loss (accrued during the period of ownership by the donor) to the donee. Therefore, under the basis rule for gifts, the cost basis for determining gain or loss cannot be determined until the gifted security is sold.

One of the peculiarities of the special loss basis rule is that the donee may realize neither gain nor loss upon a subsequent disposition of the security. Neither gain nor loss is realized if the amount realized upon the subsequent disposition by the donee is greater than the loss basis (fair market value of the property at the time of the gift) but not greater than the gain basis (the donor's adjusted basis). Brokers must apply the relevant basis rules for sales of a security acquired by gift in determining initial basis and gain or loss on subsequent sale.

Inheritance Transfers

When covered securities are transferred from a decedent or a decedent's estate, the transfer statement must indicate that the security is inherited. The transfer statement must report the date of death as the acquisition date, and the adjusted basis reported is the valuation provided by the estate representative. If the estate representative did not provide a valuation, a broker is required to report the fair market value on the date of death as the adjusted basis. The acquisition date and basis shown on the transfer statement become the acquisition date and basis for the account receiving the inherited securities.

If a fair market value of a security at the time of death cannot be ascertained, the transfer statement must indicate that the security is inherited, but can otherwise treat the security as a noncovered security, meaning that it is not subject to basis reporting. Securities transferred from a joint account where one of the joint owners is deceased are not treated as inherited and covered securities, unless the securities transferred from the deceased owner can be identified.

> *Comment: All transfers of securities from accounts marked as "deceased" and estate accounts will likely be treated by brokers as transfers of inherited securities. If valuation instructions from the estate representative are not received prior to sending the transfer statement, the broker will determine fair market value at the date of death. Please note that a broker's reporting of fair market value as the basis for inherited securities-without having received valuations provided by the estate representative-may not provide the correct basis for U.S. federal tax purposes.*

Information on Corporate Actions Affecting Cost Basis

Starting in 2011, IRC Section 6045B requires securities issuers to provide information to the IRS and holders on the quantitative effect on cost basis of corporate actions, such as a stock dividend, stock split, reorganization, redemption, stock conversion, recapitalization, corporate division or other similar actions. Issuers are able to meet the requirement to provide information to holders by posting the information on their public websites.

Please note that the provisions of new IRC Section 6045B apply to "any issuer of a specified security." Accordingly, the IRS return and holder information requirements under IRC Section 6045B apply equally to private and public corporations.

Under IRC Section 6045B(d) and Section 6045(g)(3)(B), in 2011, under the phase-in, a specified security is limited to stock in a corporation. The issuer generally must file a return with the IRS within 45 days after the organizational action. The issuer must also furnish a corresponding statement to each nominee of the stockholder, or to each stockholder, by January 15th of the year following the calendar year of the organizational action. Alternatively, the issuer is not required to file a return with the IRS if it posts the return on its primary public website in a readily accessible format by the filing date (Treas. Reg. 1.6045B-1(a)(3)).

In Notice 2011-18, the IRS provides transitional relief for 2011 from information reporting requirements in IRC Section 6045B that apply to issuers of stock with respect to organizational actions that affect the basis of the stock. The IRS will not impose penalties under IRC Section 6721 for a failure to file an issuer return with the IRS within 45 days of an organizational action taken in 2011, provided that the issuer files the return with the IRS (or posts the return on its website as provided in the regulations) by January 17, 2012.

> *Comment: The new regulations contain a special rule for S corporations. The new rule provides that an S corporation is deemed to satisfy the rules for reporting (to both the IRS and the stockholder) any organizational action affecting the basis of its stock if the corporation reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120-S) for each shareholder and furnishes these schedules to all proper parties in a timely manner. This new rule is effective for 2011.*

Summary and Conclusions

The new cost basis regulations are bound to present many challenges and questions to brokers and taxpayers alike during the first year of implementation. During the phase-in of the new regulations, it is important to note that, in many cases, the basis information reported on Form 1099-B might not reflect a taxpayer's correct basis. However, taxpayers will be expected to exercise due diligence in reporting their correct basis on Schedule D, regardless of the amount reported on Form 1099-B. Thus, taxpayers will be required to reconcile gains and losses reported on Form 1099-B to those reported on Schedule D of their tax returns.

The IRS is currently revising Schedule D and Form 1099-B and their related instructions for 2011, to provide for the information required by the new regulations. There will likely be some form of required reconciliation included in those instructions. I can already visualize the mountain of IRS notices that taxpayers will receive after they file their 2011 tax returns requesting them to explain and reconcile the differences between the gains and losses reported on Form 1099-B to those reported on Schedule D filed with the return!

If you have any questions regarding how these new cost basis rules may affect you, please contact your Schneider Downs representative at 412-261-3644..

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