

Cost Basis Reporting Law

Get the 2012 Tax Reporting FAQs

KEY HIGHLIGHTS:

- Reporting Changes - New Forms 1099-B & 8949
- What do I have to report in addition to what my broker provides?

ADDITIONAL INFORMATION:

- What is cost basis?
- What is the cost basis reporting law and when does it take effect?
- Why was this legislation enacted?
- How is cost basis calculated?
- What are the different lot relief methods for calculating cost basis?
- How does the wash sale adjustment aspect of the cost basis law work?
- What is transfer reporting?
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Learn more at www.costbasisreporting.com.

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Reporting Changes - New Forms 1099-B & 8949

As a result of the cost basis reporting law, a revised Form 1099-B is being issued for 2012 tax reporting with new boxes to list cost basis for some securities. To review this form, visit: <http://www.irs.gov/>.

The IRS in 2011 revised the Schedule D and create a new tax form for reporting capital gains and losses, Form 8949. The new form categorizes investment sales into three categories: covered security sales—the Broker will provide basis; noncovered security sales—for which the Broker will not supply basis; and, sales not reported on a Broker supplied 1099-B.

To review this form, visit: <http://www.irs.gov/>.

What do I have to report in addition to what my broker provides?

It is essential to understand that although the cost basis law requires brokers to provide taxpayers with certain cost basis information for covered securities, this information alone may not be sufficient for a taxpayer to accurately report capital gain and loss information for tax purposes.

The taxpayer ultimately remains responsible for complete and accurate tax reporting to the IRS. The following chart highlights some of the key differences between what brokers are now required to report and what taxpayers additionally still need to report.

Consult your tax adviser for additional information relevant to your particular situation.

Who is responsible for reporting what?	Taxpayer	Broker	Notes
Wash sales across multiple accounts	Required	Not required	Brokers have no obligation to track wash sales across accounts, but taxpayers do.
Adjusted basis of covered securities	Required	Required	
Adjusted basis of noncovered securities	Required	Not required	Taxpayers must still adjust basis to calculate gains/losses on noncovered securities, even though brokers are not required to provide this information.
Capital gains/losses	Required	Not required	As was required prior to this law, taxpayers are still ultimately responsible for reporting capital gains/losses, not brokers.
Wash sales across identical covered securities in each account	Required	Required	Taxpayers continue to be responsible for accounting for wash sales within each of their accounts. Starting with 2011 reporting, brokers must also account for this information for each account.
Wash sales resulting from equity transactions occurring prior to Jan. 1, 2011, from mutual fund and mutual fund and dividend reinvestment plans occurring prior to Jan. 1, 2012 and other asset classes in subsequent reporting periods	Required	Not required	Brokers do not have to track the impact of transactions on noncovered securities for wash sale deferrals, but taxpayers do.

Who is responsible for reporting what? (cont.)	Taxpayer (cont.)	Broker (cont.)	Notes (cont.)
Wash sales resulting from transactions occurring prior to when the asset class becomes covered	Required	Not required	Brokers do not have to track the impact of wash sales on mixed noncovered and covered security transaction sets, but taxpayers do.
Wash sales resulting from nonspecified securities	Required	Not required	Brokers do not have to report basis for nonspecified securities.
Transactions traversing noncovered and covered securities	Required	Not required	The law only requires brokers to report on asset classes as they become covered. However, taxpayers continue to have the gain/loss reporting responsibilities that they had prior to this law including reporting on transactions relating to noncovered securities.
Transactions resulting in a gain/loss from nonspecified securities	Required	Not required	Brokers do not have to report on certain assets, such as partnerships, certain UITs or widely held fixed investment trusts that are not specified via the law. Taxpayers still have reporting responsibilities for these assets.
Adjusted basis for securities not reported on a 1099-B	Required	Not required	
Basis adjustments for open short sales	Required	Not required	Brokers do not have to report basis for open short sales, (except for short sales closed with covered securities) yet taxpayers must report the sale transaction when actually closed, including for noncovered securities.
Basis adjustments resulting from exercised options	Required		Brokers do not have to report basis for exercised options, yet taxpayers must.
Corporate actions affecting the basis of noncovered securities	Required	Not required	As was required prior to this law, taxpayers are still responsible for the effect of corporate actions to the basis of stock securities they purchased before 2011 and mutual fund or DRP shares purchased before 2012 – noncovered securities. However, brokers do not have to report this information for noncovered securities.

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Adjusted Basis for Covered Securities

Brokers are required to report cost basis adjusted for corporate actions and wash sales for identical securities within each client account, and to account for holding periods for covered securities. Important to note is that some brokers may report basis of covered lots only. Taxpayers must also report adjusted basis of covered securities.

Adjusted Basis for Noncovered Securities

Brokers are not required to report basis of or to account for the tax effect of corporate actions on noncovered securities, although some may. To correctly compute and report proceeds, however, taxpayers must continue to practice due diligence adjusting basis for corporate actions and wash sales for noncovered securities, with no time limitation.

Adjusted Basis for Nonspecified Securities

Another category of securities that taxpayers must pay attention to is nonspecified securities. For tax purposes equities, mutual funds, options and debt are the prominent securities of Broker interest. Many securities may be generally classified in these broad categories but may not meet the broker tax reporting definitions under this law—like certain unit investment trusts, exchange traded funds, partnerships, exchange traded notes or foreign mutual funds. As a result, these are considered nonspecified securities. Although brokers are not required to report the basis of nonspecified securities, taxpayers have to report on them.

Realized Gain/Loss Reporting

Brokers do not have to report capital gains and losses. However, taxpayers must compute gains and losses for all trading activity.

Wash Sales

Brokers are responsible for reporting wash sales for identical covered securities within each client account. Brokers are not responsible for reporting wash sales across multiple accounts or for wash sales/deferrals resulting from transactions that took place prior to when the security type becomes covered via the law or for nonspecified securities.

Taxpayers are also responsible for reporting wash sales within each account and additionally for aggregating wash sales across accounts including across multiple accounts within the same broker. Further, if a pre-effective date transaction results in a post-effective date wash sale, taxpayers must account for this event also.

For example, if stock was owned prior to January 1, 2011, sold at a loss on December 15, 2010 and bought again on January 5, 2011, the investor incurs a wash sale. Since the broker is not responsible for tracking wash sales prior to this law, the broker does not have the information and it is the taxpayer's responsibility to track and report this.

Exercised Options

Brokers do not have to report premium adjustments resulting from exercised options. Yet taxpayers must account for these basis adjustments resulting from exercised options.

Burden of Reconciliation

Finally, due to the differing reporting obligations of the taxpayer and the broker, it is ultimately the taxpayer's responsibility to correctly reconcile any differences in basis and proceeds and to accurately report to the IRS.

It is strongly advised that you consult with your professional tax advisor to report required information in addition to what your broker provides since the cost basis information that your broker is required to provide to you the taxpayer might not be sufficient for you to accurately report capital gain and loss information for 2012 tax purposes.

What is cost basis?

Generally, cost basis is the adjusted original purchase price of investment securities used to calculate capital gains or losses for tax reporting. The cost basis is adjusted to reflect the effect of corporate actions and wash sales as well as fees and commissions.

What is the cost basis reporting law and when does it take effect?

Cost basis reporting became law as part of the 2008 Emergency Economic Stabilization Act. This law requires brokers to report cost basis to taxpayers and the IRS. Basis must be adjusted to reflect corporate actions, wash sales and holding period.

Brokers are only obligated to report cost basis on a subset of transactions. The investor must report cost basis on all transactions.

The required reporting of adjusted cost basis by brokers to taxpayers and to the IRS generally applies to what are known as 'covered securities' as follows:

- Most stock acquired on or after January 1, 2011
- Mutual funds, Registered Investment Companies (RICs) and some dividend reinvestment plan (DRP) shares that meet certain qualifications acquired on or after January 1, 2012
- Options and debt instruments acquired on or after January 1, 2014
- Additional asset classes over time, as the IRS deems compulsory

A Note on Account Transfers

- Important to note is that when these securities are transferred between brokerage accounts, transferring brokers will now be required to report the cost basis information to the receiving brokers with the transfer.

Why was this legislation enacted?

In 2006, the Government Accountability Office of the IRS determined that some 38% of individual taxpayers with securities transactions misreported capital gains and losses to the tune of billions of dollars each year. Subsequently, Congress forged the legislation to help the IRS close the tax gap and collect that missing revenue. In October of 2008, cost basis reporting became law as part of the Emergency Economic Stabilization Act.

What are the different lot relief methods for calculating cost basis?

It is essential to understand as a result of the cost basis reporting law that brokers and investors must manage depletion methods with either standing orders or confirm instructions prior to trade settlement date.

There are different depletion—or lot relief—methods for calculating cost basis to be aware of: FIFO, variations of Specific Identification—or Designated Lot, and Average Cost.

First-In, First-Out (FIFO) — Perhaps the simplest, this is the most commonly used method for determining cost basis. Quite simply, the oldest shares (or those first shares purchased and first-in the shareholder's account) are sold first (first-out).

Specific Identification—Additionally, the cost basis law requires that brokers give shareholders the flexibility to select their preferred depletion method. There are several Specific ID methods including:

- **Last-In, First-Out (LIFO)** – The newest shares (those most recently purchased or last-in the shareholder's account) are sold first (first-out)
- **High-Cost** – The shares in an account that cost the most are sold first
- **Low-Cost** – The shares in an account that cost the least are sold first
- **Specific lot** – Shareholders specify which shares or lots are depleted each time there is a sale

The cost basis law makes it clear that for stock, the FIFO lot relief method must be used in determining the cost basis of shares sold unless the customer specifies a different method to his or her broker (or a standing order has been provided to the broker) prior to the settlement date or the sale.

Average Cost — This is the most common cost basis calculation method used for mutual fund shareholders. The average cost of shares is calculated by using an average price of all the shares purchased. Under the cost basis reporting law, average cost has been extended to cover certain qualified stock dividend reinvestment plans.

Taxpayers electing averaging will need to report when the average basis depletion method was utilized by entering "AV" onto the 8949 form.

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How does the wash sale adjustment aspect of the cost basis law work?

Wash Sales – An Introduction

Generally, the wash sale rule prohibits shareholders from claiming a loss on the sale of shares during a 61-day period starting 30 days before the sale, including the day of the sale and continuing 30 days after the sale. Sales during that time disallow claiming the loss for tax purposes, hence resulting in a wash sale.

However, even though shareholders can't claim the loss of a wash sale, the disallowed amount is added to the cost of the repurchased shares, enabling shareholders to recognize the loss when the repurchased shares are finally sold.

Wash Sales Under Cost Basis Reporting

As part of the cost basis reporting law, brokers are required to make certain adjustments for wash sales. Specifically, brokers are responsible for reporting wash sales for identical covered securities within each client account.

Brokers are not responsible for reporting wash sales across multiple accounts or against non-identical securities. Brokers are not responsible for reporting wash sales/deferrals resulting from transactions that took place prior to when the security type becomes covered—which would be wash sales across covered and noncovered securities. Brokers are not responsible for wash sales across nonspecified securities—which are those that the law does not specify as having to be covered, such as partnerships.

Taxpayers are also responsible for reporting wash sales within each account and additionally for aggregating wash sales across accounts, including across multiple accounts within the same broker. Further, if a pre-effective date transaction results in a post-effective date wash sale, taxpayers must account for this event—which would be wash sales across covered and noncovered securities. Additionally, taxpayers must report on nonspecified securities.

What is transfer reporting?

As a result of the cost basis law, when investors transfer securities to different brokerage firms, the transferor broker must provide the transferee's broker with transfer statements detailing the cost basis of covered securities and certain other information within 15 days of the date of transfer. This is to ensure that your adjusted basis for transferred securities is included with the transfer transactions.

Transferors subject to transfer reporting include brokers, stock transfer agents, custodians, stock issuers, and their agents.

A transferor is required to issue corrected transfer statements for changes in information related to cost basis (such as transfer statements received, issuer corporate action statements and inheritance values provided by authorized representatives) within 18 months of the date a transfer statement was provided.

Receiving transferees must still review transfer statements received and are required to contact the transferor and request a complete transfer statement if the statement received is incomplete unless the transferor has no duty to deliver a transfer statement (such as a transfer for an exempt recipient).

What other events might impact cost basis under this law?

The following are some events that could potentially impact a shareholder's cost basis.

Inherited Shares – To calculate the cost basis of inherited shares—shares acquired following the death of an individual, generally the value of shares on the date of the decedent's death is applied.

However, with the cost basis law, that valuation would need to reflect corporate actions that may occur between the date of death and conveyance of those shares to the recipient. In the case of reporting of inheritance related transfers, the broker does not need to contact the representative of estate and request values as of date of death for transferred securities. The transferor must compute the fair market value of securities as of the date of transfer if values not provided by an authorized representative but only to extent fair market values are readily ascertainable.

For inherited shares, taxpayers will need to report gain/loss and note "INHERITED" on the 8949 form.

Gifted Shares – There are a multitude of considerations regarding the basis of gifted shares, such as whether the fair market value is greater or lesser than donor's cost basis on the gift date, as this may affect the recipient's cost basis.

Return of Capital – Return of capital, such as an income dividend distribution for a mutual fund is non-taxable and generally reduces the basis for the shares receiving the return of capital.

What does the cost basis law mean for active traders and investors?

Brokers are now required to provide a subset of cost basis information to taxpayers. In the case of active traders and investors, this information may not be sufficient.

In short, starting with 2011 tax reporting, the 1099-B forms that you—and the IRS receive from brokers will now have additional boxes in which the required adjusted cost basis for covered securities as well as wash sales will be listed. The 1099-B instructions will state that taxpayers must verify that the information reported by brokers is correct or make the necessary adjustments to the reported information if it is incorrect. So, although brokerage firms are accountable for reporting within these new IRS requirements, the taxpayer remains fully accountable for accurate tax preparation and filing.

Further, the IRS will now have more information to flag tax reporting errors, enforce rules and collect taxes. Specifically, the IRS will receive two numbers for each covered sale: total cost basis, and total sale proceeds. The difference will provide a gauge of what taxpayers should be reporting as a gain or loss and can be applied as an audit flag to help identify 'mistaken' capital gains or losses.

What's New for 2012?

- Starting in 2012, brokers must report adjusted cost basis for covered mutual fund and DRP shares—as well as for the covered securities that they have been required to report on since 2011, to taxpayers and to the IRS
- Additionally, issuers to report organizational actions that have a quantitative effect on basis of their securities on new IRS Form 8937, and brokers must account for this information.
- As a result, the IRS will now have more information to flag tax reporting errors, enforce rules and collect taxes
- Yet you—not your brokers, are responsible for verifying that your broker-reported 1099-B information is correct
- Further, if you have multiple brokerage accounts, you are responsible for reporting wash sales—including those between stocks and options—across all of your accounts
- You are also responsible for tracking wash sales between covered and noncovered shares within an account

How does the cost basis law impact Mark-to-Market elections?

Also essential to understand is that taxpayers are also responsible for reporting wash sales within each account and additionally for aggregating wash sales across accounts including across multiple accounts within the same broker. Further, if a pre-effective date transaction results in a post-effective date wash sale, taxpayers must account for this event also.

Mark-to-Market Election Wash Sale Exception

Generally, active traders who have made the Internal Revenue Code Sec. 475 mark-to-market election are largely exempt from the wash sale basis adjustments and loss deferrals required by this law IF they have properly notified their broker of this election and IF their entire account solely contains assets subject to the mark-to-market election. However, brokers must still provide cost basis information for covered securities to such customers (not adjusted for wash sales) on Form 1099-B.

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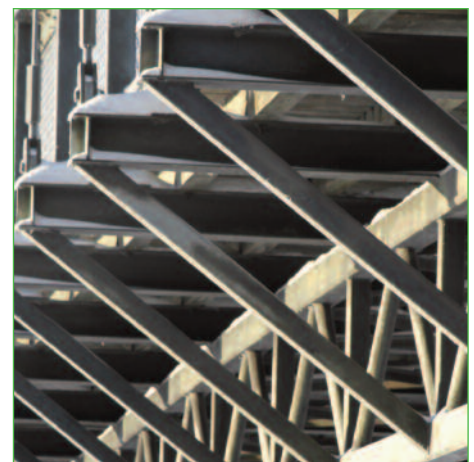
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Wolters Kluwer Financial Services Headquarters

100 South 5th Street
Suite 700
Minneapolis, MN 55402-1466
800-472-1009 option 2

Wolters Kluwer Financial Services | GainsKeeper

130 Turner Street
Building 3, 4th Floor
Waltham, MA 02453



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