

Corporate Action Issuer Returns – Cost Basis Challenges for Brokers

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Introduction

The cost basis reporting law (CBRL) enacted in 2008 imposed new tax reporting obligations on issuers of specified securities such as stock, mutual fund shares, options and debt instruments that require them to report the quantitative effect on basis of corporate actions under Internal Revenue Code Section 6045B (Issuer Reporting). The new rules apply to corporate actions involving stock (other than mutual fund shares) beginning in 2011 (regardless of when the stock was issued) and to corporate actions involving other types of specified securities occurring in 2012 and later. Issuers are generally required to report corporate actions under these new rules to the IRS (Issuer Returns) within 45 days of the date of the corporate action and to provide information statements to holders of the affected security by January 15 of the following calendar year. Issuer Returns can be filed with the IRS and provided to holders or, alternatively, issuers can satisfy this requirement by simply posting the required IRS Form 8937 on their public websites for 10 years (Public Website Option). Under the CBRL, brokers are required to take into account any basis adjustments reported by issuers on Issuer Returns in computing cost basis reported to investors on Form 1099-B.

Concerns with new IRS Form 8937

When the new CBRL reporting rules went into effect in 2011 for corporate actions relating to stock, issuers had few clear guidelines on how to comply with their Issuer Reporting obligations. No Issuer Reporting form or instructions had been issued at the beginning of 2011. So the IRS issued Notice 2011-18 which provided penalty relief for failing to timely file Issuer Returns provided such returns were filed no later than January 17, 2012. A draft IRS Form 8937 for Issuer Reporting was released in March of 2011, and a revised draft form was released in November 2011. The final version of Form 8937, and the related instructions, were published on January 5, 2012, only 12 days before the initial January 17, 2012 filing deadline.

Issuers and their tax advisors have expressed concerns about final Form 8937, the related instructions and the release of the form immediately before the January 17, 2012 initial deadline. In response, on January 13, 2012, the IRS issued Notice 2012-11, which does not extend the January 17, 2012 deadline, but does offer some relief for issuers that are working diligently to meet the new requirement. Notice 2012-11 provides that an issuer using the Public Website Option may post either completed Form 8937, or the required information, and provides penalty relief for incorrect filling if the issuer makes good faith efforts to timely post the information or Form 8937 on its website under the Public Website Option or to timely file Form 8937 and provide holder statements.



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Vague Instructions and Concerns About Few Issuer Returns Filed

Final IRS Form 8937, Report of Organizational Actions Affecting Basis of Securities, together with its instructions, gives very few specifics on the level of detail and amount of information issuers must provide. Notice 2012-11 essentially acknowledges this criticism by providing issuers with penalty relief for incorrectly completing the form. This is troubling considering that the Issuer Returns published in 2011 show a variety of approaches and a good deal of variance in the amount of actionable information the returns provide. Another concern is that as of mid January 2012, only about 60 or so Issuer Returns have been made public on issuer websites out of the several thousand corporate actions occurring in 2011 that are presumably subject to Issuer Reporting.

Issuer Reporting by U.S. companies should become more widespread as issuers become more aware of the reporting requirement. But compliance by non-U.S. companies, from which it is often difficult to obtain U.S. tax information, is more doubtful. Worthy of note is that only three of the Capital Changes Top 10 Corporate Actions for 2011 had accompanying Issuer Returns. With only one of these being a non-U.S. company, the question of the degree of compliance with Issuer Reporting by non-U.S. companies becomes a pressing one.

Challenges of Issuer Reporting

A key challenge brokers face in complying with the CBRL is that they are required to adjust the basis of covered securities for corporate actions. Although Issuer Reporting is intended to provide brokers the information regarding corporate actions to make such basis adjustments, there are several noteworthy problems. As mentioned earlier, there is concern that many issuers are not yet complying with Issuer Reporting and the lack of compliance may be a particular problem for issuers of foreign stock. In addition, unless an issuer elects to report corporate actions on its public website under the Public Website Option, Form 8937 is delivered to the IRS and to holders of record—they do not have to be provided directly to brokers or made publicly available. Moreover, Form 8937 does not need to be provided to holders until January 15 of the calendar year following the corporate action—which likely does not give brokers enough time to process information because they are already busy preparing Form 1099s for delivery to investors by the February 15 deadline.

There are also potential problems that brokers must address even in those cases where issuers elect to report corporate actions on their public websites. Brokers will need to monitor issuers' websites when corporate actions occur to see if Form 8937 Issuer Reporting information is posted. Brokers will also likely need to make multiple visits to company websites over the 45-day filing period occurring after the date of a corporate action. Issuers are required to correct information reported on Form 8937 at any time (there is no "cutoff

date" after which they are not obligated to update such returns for new or corrected information) and brokers will need to continually monitor websites to see whether corrected pages or updates are posted. There may also be practical problems in navigating through the different levels and pages of an issuer's website because each company may have its own approach regarding where it posts and how it categorizes its Issuer Returns under the Public Website Option.

Many Issuer Returns filed to date have also included lengthy tax discussions, as might be found in a prospectus or proxy statement, and some also qualify their conclusions, or provide alternative tax outcomes, based on factual or legal assumptions that may be difficult to understand. Despite these obstacles, brokers are required under the CBRL regulations to take into account all information furnished on an Issuer Return when reporting the sale or transfer of a security.

Form 8937

The final version of Form 8937 includes boxes for issuer name, contact, and other basic information. Part II of the Form, titled "Organizational Action," includes new boxes 14 through 19 that, while still leaving room for a narrative, ask for the following:

1. Describe the organizational action and, if applicable, the date of the action or the date against which shareholders' ownership is measured for the action
2. Describe the quantitative effect of the organizational action on the basis of the security in the hands of a U.S. taxpayer as an adjustment per share or as a percentage of old basis
3. Describe the calculation of the change in basis and the data that supports the calculation, such as the market values of securities and the valuation dates
4. List the applicable Internal Revenue Code section(s) and subsection(s) upon which the tax treatment is based
5. Can any resulting loss be recognized?
6. Provide any other information necessary to implement the adjustment, such as the reportable tax year

As indicated earlier, although detailed, the requirements leave much room for creative (and possibly confusing) narrative by issuers. The instructions provide that money market funds subject to Rule 2a-7 are not required to file Form 8937.

Issuer Returns Not Required for Every Corporate Action

It is important to bear in mind that Issuer Returns are not required for every corporate action. An Issuer Return is required only in the following circumstances:

1. It must be provided by the issuer of a specified security
2. The issuer must be taking a corporate action
3. The action must affect the basis of the security

The instructions state that Issuer Reporting does not apply to initial public offerings of stock. They also provide that Issuer Reporting does not apply to the issuance of stock pursuant to a previously issued stock right or warrant.

The instructions also contain a sentence that has caused some debate concerning the scope of the Issuer Return requirement. It states: "File Form 8937 only when an organizational action affects the basis of all holders of a security or all holders of a class of security." An example illustrating the sentence indicates that an Issuer Return is not required when someone exercises a stock purchase right. It seems also to cover corporate stock buyback programs, which create only a theoretical possibility of an effect on tax basis under the section 302 rules governing redemptions. But we understand that some corporations may be relying on the sentence in not reporting on corporate acquisitions involving the issuance of stock. Such an interpretation is not consistent with the prior corporate practice described below and would be a substantial restriction on the utility to brokers of Issuer Returns.

In the strictest sense, the requirements listed above exclude issuers who are not taking a corporate action, such as a company that is the target of a hostile takeover, where the acquirer is taking the action but its securities are unaffected. By the same token, in a complex merger or reorganization, it may be unclear which of multiple companies involved will undertake the responsibility for providing the Issuer Return. This may complicate matters for brokers contacting companies and checking company websites for Issuer Returns.

More problematic is the fact that an Issuer Return is required only if the corporate action has an effect on basis. The instructions to Form 8937 provide that Form 8937 does not need to be filed for a cash distribution such as a dividend that is entirely taxable. However, determining whether a distribution is taxable may depend on facts that are not known at the time of distribution, such as the earnings and profits of the issuer for the current tax year. The issuer may make reasonable assumptions to report the effect on basis, and if, by the reporting deadline, the issuer is unable to determine what portion of a distribution is a dividend or return of capital, the issuer must treat the entire amount of the distribution as a dividend, Treas. Reg. 1.6045B-1(a)(2)(ii). At the end of the company's fiscal year, however, it may

happen that the company has insufficient earnings and profits to cover the dividends paid out during the course of the year. Any excess distributions would be recharacterized as a return of capital, which reduces the basis of the shares on which the payments were made. In this case, because the distribution was not entirely taxable, taking into account the subsequent facts, the issuer would be required to file Form 8937 reporting the portion of the distribution that is a return of capital.

The problem with analyzing distributions based on subsequent determinations of earnings and profits could be further exacerbated if some dividends were paid out of accumulated earnings and some out of current earnings, or as in the case of the 2010 special dividend by Weyerhaeuser, accumulated earnings prior to 1913. These sorts of circumstances could retroactively affect prior distributions throughout the tax year and require Issuer Reporting for several payments.

Issuer Returns probably should not be expected for simple events such as name changes or ticker changes. The same is likely true for cash mergers, tender offers and stock buy-back plans, but there could be exceptions. For instance, a call or redemption, where the company purchases its own shares for cash, may be treated as a dividend under Sec. 302 of the Internal Revenue Code. As discussed above, dividend payments have the potential to result in a return of capital which would reduce the basis of the shares on which it was paid.

One type of corporate action that may be open to interpretation is a stock-for-stock merger. If the event is nontaxable, and there is no cash consideration, aggregate basis carries forward 100 percent. Does that mean there is no effect on basis? What if the number of shares changes from the old company stock to the new company stock? The aggregate basis remains the same, but on a per-share basis, it is different.

In correspondence with one issuer asking whether an Issuer Return would be posted, the company replied as follows:

CenturyLink's acquisition of Qwest is a non-taxable, stock-for-stock transaction. It does not affect basis. For example, if you own 100 shares of Qwest purchased for \$5 per share, your basis is \$500. After the conversion of Qwest shares to CenturyLink shares at the rate of .1664, you will own 16.64 shares of CTL with a basis of \$500. Total basis is not affected, only basis per share.

The question changes if the stock-for-stock merger is fully taxable. In this case, and for taxable stock distributions as well, the basis of the old security may not change, but the holder will have a new basis in the new security. The general rule for taxable mergers and distributions is that the basis of the security received equals its fair market value at the time of receipt, and the holding period begins on the following day. This is critical information for a broker to have, but it is unclear that an Issuer Return is required for such events.

Corporate Action Issuer Returns

How Many Issuer Returns Are Expected?

As of the end of 2011, Capital Changes reported more than 6,500 corporate actions for the year. Taking the category of mergers and exchanges as an example, Capital Changes reported about 2,000 events, including both taxable and nontaxable transactions. Other events in the 6,500 corporate actions include taxable distributions, including cash dividends (that if recharacterized as return of capital would require an Issuer Return), other taxable events where stock is received, and foreign events where no U.S. tax opinion was provided. It is hard to estimate at this point how many Issuer Returns to expect, but based on the above numbers, we can readily anticipate several thousand reportable events every year.

Review of Issuer Returns to Date

In 2010, before the final IRS CBRL regulations were issued and any Issuer Returns had been published, there was a widely held belief that Issuer Reporting would be a magic bullet to provide brokers with corporate actions adjustments needed for dealing with the effects on basis of corporate actions. After all, under the CBRL, issuers are required to provide basis information for specified securities involved in a corporate action and brokers are entitled to rely on what they report.

Brokers are required to take Issuer Returns into account in determining cost basis of covered securities for reporting sales and transfers, and Issuer Returns have the potential to provide useful information about the corporate action and the quantitative effect on basis. But how useful have they been so far, and what can we expect going forward?

This paper examines some Issuer Returns that have been filed to date. These statements include reports of mergers, stock splits, spin-offs and other distributions, and even note issuances, dividend reinvestment plans, and a restricted stock bonus plan. While the returns generally set out the main elements required by Treas. Reg. 1.6045B-1 (information about the issuer, security, contact person, type of action, and effect on basis) they vary widely in the amount of detail provided. This is not surprising since a stock split is much simpler than a merger.

For example, the statement filed in the Comm Bancorp merger by the acquirer, FNB Corp. is only two pages long, whereas the statement for the T-3 Energy Services merger, filed by the acquirer Robbins & Myers, is nine pages long. As the filing becomes longer, brokers and investors will have to sift through lengthier sections of text in order to extract the relevant points.

Providing a number:

The most reliable way to adjust the basis of a security is to have a number, either an allocation percentage or a fair market value. Certain types of corporate actions lend themselves well to this approach, e.g. stock splits/dividends, spin-offs, taxable mergers/distributions. Some Issuer Returns have taken this approach.

The Issuer Return HCA Holdings, Inc. provided, for a 4.505-for-1 stock split, described the effect on basis as follows:

The Stock Split resulted in the allocation of the tax basis with respect to a particular share ratably among the shares held immediately after the stock dividend with respect to that share under Section 307(a) of the Code. Thus, a shareholder will multiply the basis in each share held before the Stock Split by 0.22197558 (1/4.505) to determine basis in each share held immediately after the Stock Split. Any cash received in lieu of a fractional share(s) will be treated as though the shareholder received the fractional share(s), which were immediately after redeemed by HCA in a taxable sale.

In another example, Crescent Point Energy Corp., a Canadian company, provided three separate Issuer Returns for its (1) dividend reinvestment plan, (2) annual performance award, and (3) restricted stock bonus plan. In each instance it provided the fair market value, in Canadian and U.S. dollars, for the respective issue dates.

Motorola, Inc. took a similar approach in reporting its spin-off of Motorola Mobility Holdings, Inc. and reverse split, but with a twist. The Issuer Return stated the general rule, and was similar to an information statement provided before the spin-off and reverse split. The Issuer Return then referred the reader to an attached, previously published shareholder tax basis information statement, the same type of statement that has been generally provided by companies for spin-off basis allocations prior to CBRL. This resulted in a five page document with concrete numbers appearing near the end.

A hybrid approach, demonstrating the problems inherent in corporate actions involving uncertain tax situations, is the American International Group (AIG) Issuer Return regarding its distribution of warrants in January 2011. This Issuer Return provided concrete numbers but originally left open the possibility that the final outcome might be different. The company noted that, absent any subsequent determination by the IRS that the warrant distribution was nontaxable, the distribution would be treated as taxable. It provided the market values to be used for reporting the distribution as a taxable dividend with no effect on basis. The company also gave the market values and percentage basis allocations to be used in the event that it was determined that the distribution was nontaxable and resulted in an allocation of basis. The reported information was dramatically revised at the end of 2011, when the company amended its Issuer Return to disclose that the distribution was neither a taxable or nontaxable distribution, but was actually a return of capital resulting in a reduction of basis. This could be a sign of things to come as Issuer Returns become routinely revised and corrected for subsequent changes in relevant facts affecting the character of distributions.

Restating the rule:

In the absence of a concrete number, the next best thing is to know which basis adjustment rule applies in the specific instance. A number of Issuer Returns have taken the latter approach.

Thus, Advent Software, Inc., in reporting a 2-for-1 split of its common stock, rather than provide the applicable basis allocation factor (50 percent) in the Issuer Return, described the corresponding rule:

The Stock Split resulted in the allocation of the existing tax basis in the Advent common stock held equally between the existing share and the share received in the stock dividend. Sec. 307(a) of the Code.

One type of corporate action that is not readily amenable to a one-size-fits-all number is a merger with boot — typically a merger where the shareholder receives a combination of stock and cash. Basis adjustments in this type of event are challenging because they depend on the amount of gain, if any, recognized, which in turn depends on the basis of each holder's existing securities prior to the merger. In such cases, issuers have little choice but to state the general rule and let each shareholder, or their brokers, calculate the new basis for each lot of stock held.

Thus, when FNB Corp. acquired Comm Bancorp Inc., the Issuer Return described the quantitative effect on basis as follows:

In general, the aggregate tax basis in the shares of FNB common stock that the CBO shareholders receives pursuant to the consummation of the merger will equal such holders' aggregate tax basis in the CBI shares surrendered, increased by the amount of taxable gain, if any, that such holder recognized in the merger (excluding any gain or loss resulting from the deemed receipt and sale of fractional shares described below), and decreased by the amount of (i) any cash received (excluding any cash received in lieu of fractional share of FNB common stock) in the merger and (ii) basis allocated to the fractional shares, if any, such holder was deemed to receive and subsequently sell.

Another example of an Issuer Return that restates the general rule is German American Bancorp, Inc.

Providing alternative outcomes:

The least helpful approach for brokers and holders in describing the quantitative effect on basis of a corporate action is to discuss what would happen if the event is ultimately determined to be taxable, on one hand, or nontaxable, on the other, without taking a position as to which outcome is more likely. This approach was taken in the Issuer Return provided by Just Energy Exchange Corp. Although this is the only example for Issuer Returns so far, it is a relatively common approach in proxy statements and similar documents.

The Issuer Returns published to date run the gamut from providing a relatively clear explanation of the required basis adjustment to intricate

tax analysis that replicates information provided in an SEC filing. Noteworthy in the Motorola Issuer Return, the company provided a generic description of the basis adjustment required in the spin-off and reverse split, but not the actual basis allocation percentages which were provided in a separate press release.

Other corporate descriptions of corporate actions mandated by IRS

Form 1099-CAP, Changes in Corporate Control and Capital Structure, has been required since 2003 for reporting of shareholders' receipt of cash and property in connection with certain changes in corporate control and capital structure. Form 8806, Information Return for Acquisition of Control or Substantial Change in Capital Structure, is also required for such events, and permits the issuer to consent to disclosure by the IRS of some of the return's contents. This IRS disclosure is done on the IRS website. Examination of these disclosures shows a wide variety of descriptions of corporate actions that are not necessarily clear or helpful. For example, ENSCO International Inc.'s disclosure of its December 23, 2009 merger resulting in its change of domicile from Delaware to the United Kingdom states that shareholders are required to recognize gain, and gives a fair market value of the shares received in the merger, but lacks detail of the calculation or the fact that no loss can be recognized.

It seems likely that the Issuer Reporting requirements set forth in the instructions to Form 8937 will be construed as allowing differences in the amount of detail contained in Issuer Returns. Some standardization has emerged over the years in the reporting by issuers of shareholder tax basis information for spin-offs. Companies often post information statements to their websites explaining the allocation of basis to stock received in a nontaxable distribution and giving examples of basis allocation using one or more sets of fair market values. These statements also include statements required by Treas. Reg. 1.355-5(b) to be filed with tax returns by significant distributees, those shareholders owning five percent or more of the distributing corporation's stock or owning the corporation's securities with an aggregate tax basis of \$1 million or more. Although they tend to follow a pattern, the information statements vary widely and often include up to four possible basis allocations based on different market values.

Conclusion

Issuer Returns have not been the hoped-for panacea for brokers in computing corporate action related basis adjustments. Based on the final form, comments on the related instructions as indicated in Notice 2012-11 and the Issuer Returns that Capital Changes has reviewed so far, Issuer Returns may provide brokers' with substantially less assistance in complying with the CBRL than had been hoped. The value of Issuer Returns may be further undermined to the extent the issuer is unwilling or unable to take a clear position on the taxability of corporate actions.



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