

Newly Enacted Cost Basis Reporting Law Presents Broker Challenges

By Stevie D. Conlon, Tax Director, GainsKeeper, Wolters Kluwer Financial Services

Cost basis reporting by brokers is now law. It was included in the tax extenders and energy provisions that were a last minute addition to the financial bailout bill (H.R. 1424) that was signed into law by President Bush on Friday, October 3, 2008 (the Act, Pub. L. No. 110-343).

The details of the cost basis reporting provisions as enacted are essentially the same as the version included in the May 8, 2008 House version of the Housing Act with only minor changes in coverage details and a one year delay in effective dates.

Significantly, the three-tier staggered effective dates for cost basis reporting as enacted are: stock acquired on or after Jan. 1, 2011; open-end and closed-end mutual funds and dividend reinvestment plan (or similar arrangements) (DRIP) shares acquired on or after Jan. 1, 2012; and debt instruments, options and other IRS-selected securities acquired on or after Jan. 1, 2013. These effective dates leave only two years or so to prepare for cost basis reporting for stock.

This could be complicated and time consuming.

Although the delayed effective dates for mutual fund and DRIP shares and debt and options may be viewed as beneficial, the reality is that the computational issues regarding such instruments are significantly greater, meaning that the additional time is offset by the additional development and implementation work that is necessary to prepare for cost basis reporting for such instruments.

Cost basis reporting presents a number of challenges and risks for brokers. The most significant is tax penalty risk if the basis and holding period information reported on Form 1099-B is incorrect. There are separate penalties for 1099s provided to the IRS and 1099s provided to taxpayers, and they aggregate to \$100 per incorrect 1099 (with an annual maximum of \$350,000 per year before interest). If the error is due to intentional disregard, the combined penalties are 10 percent of the amount that should have been reported (without any maximum limit). Avoiding the stigma and potential amount of these penalties requires greater accuracy and attention to detail in broker cost basis and holding period computations that underlie the 1099 information.

The two fundamental areas of necessary focus under the new cost basis reporting law are on the proper processing of corporate actions that affect cost basis and the proper adjustments to basis triggered by wash sale loss deferrals required under the tax law. The Act makes brokers responsible for both of these types of basis adjustments. It is also necessary to track the related adjustments to holding periods of stocks and securities so that proper short-term and long-term classifications can be made as required under the new cost basis reporting rules.

The cost basis reporting rules recognize these difficulties and include provisions that are intended to assist brokers with these burdens. Issuers of stocks and securities are required to report to holders the quantitative effect of each corporate action on basis (corporate action basis reporting). Brokers are also required to adjust for wash sales in computing and reporting adjusted basis using two key simplifying assumptions: 1. only identical securities (determined by CUSIP) are subject to wash sales for cost basis reporting purposes (rather than substantially identical securities) and 2. only wash sales within a single account need to be taken into account (rather than wash sales between different accounts of the same taxpayer).

These provisions however, still leave substantial computational burdens for brokers. For example, in many cases foreign stocks and securities issuers do not provide information on the tax treatment of corporate actions, and it is unclear whether cost basis reporting required corporate action basis reporting will rectify this shortcoming. If it doesn't, brokers could be left with making difficult basis determinations relating to corporate actions on foreign stocks and securities. Also, the wash sale rules are often complicated in real world application because of the required adjustments that routinely occur when the size of the lot sold at a loss is different from the size of the acquired lot that triggers the wash sale. The required adjustments needed to accurately track basis and holding period adjustments can strain data systems and processes. Brokers need to carefully assess whether systems that purportedly compute wash sales adjustments are accurate enough given the penalty risks.

Mutual fund and DRIP shares raise their own computational issues because of permitted averaging of basis. The averaging rules have their own technical complexities that need to be considered, and as a threshold matter, must decide whether to elect to include pre-effective date (grandfathered) shares in the averaging computations. Also, customers can elect out of any broker selected basis computation method for fund and DRIP shares, so brokers' systems need to be able to compute basis for such shares under first-in/first-out (FIFO) or specific identification as well. Debt securities become subject to cost basis reporting for securities acquired on or after Jan. 1, 2013 under the cost basis reporting legislation. Debt securities are subject to a number of computations that affect cost basis. For example, some debt securities are issued with original issue discount (OID) that accrues over the life of the security and the accretions are added to the holder's basis. Also, debt securities are regularly purchased at a discount or a premium, and the tax law permits or mandates the adjustment to the holder's basis in securities for amortized premium and accrued market discount.

Although these computations are mechanical and fairly well understood, they are involved and will likely require special attention in brokers' efforts to prepare for cost basis reporting. The tax rules for mortgage-backed debt instruments and REMIC regular interests are even more complicated, and such instruments and interests are also subject to cost basis reporting as debt securities.

Cost basis reporting for options will likely also be difficult. Prior to the enactment of cost basis reporting under the Act, there was no Form 1099 reporting requirement for options. As a result, the necessary infrastructure for options tax reporting must be developed from the ground up. The proper tax treatment of options and the automation of the necessary information and tax rules also needs to be developed. This could be complicated and time consuming.

As discussed above, there are significant challenges to brokers presented by the newly enacted cost basis reporting legislation. These challenges merely represent the tip of the iceberg. There are many important details and other questions that need to be considered, such as the transfer of basis information from one broker to another, and the applicability of basis adjustments on securities transferred as a gift or upon a holder's death. Given that cost basis reporting is now law and the complexity of the potential issues involved, brokers must seriously consider which steps should be taken now in order to minimize the potential pain that will likely be incurred in preparing for the looming effective dates of these new IRS broker cost basis reporting requirements.

Reprinted by permission from The Dividend Digest Fall 2008. Copyright 2008. All rights reserved. The Dividend Division is an affiliate of the Securities Industry and Financial Markets Association.
