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New Cost Basis Reporting Law Creates Challenges for Brokers

*By Stevie D. Conlon**

Stevie D. Conlon examines a provision in the Emergency Economic Stabilization Act of 2008 that requires brokers to expand information reporting to the IRS in connection with securities sales to include the adjusted cost basis of securities sold and whether the related gain or loss is long term or short term.

The Emergency Economic Stabilization Act of 2008 ("the Act")[1] includes a provision requiring brokers to expand information reporting to the IRS in connection with securities sales to include the adjusted cost basis of securities sold and whether the related gain or loss is long term or short term.[2] Broker reporting of cost basis creates significant challenges for brokers.

Background

Previously, brokers provided the IRS and taxpayers with an information return (Form 1099-B) setting forth gross proceeds received in connection with the disposition of certain securities.[3] However, brokers were not required to provide adjusted basis or holding period related gain/loss information.

Mandating broker cost basis reporting stems from earlier legislative proposals and recommendations that began in 2006.[4] In May 2007, the Staff of the Senate Finance Committee released a draft cost basis reporting proposal and solicited industry comment.[5]

Cost basis reporting was included in two separate bills that were passed by the House in December, 2007 but it subsequently died in the Senate.[6] It was also passed by the House in an earlier version of the Housing Assistance Tax Act of 2008 but was not included in the version that became law in July 2008.[7] Except for effective dates, the version of cost basis reporting that became law as part of the Act is almost identical to the version included in the Housing Assistance Tax Act as passed by the House on May 8, 2008.[8]

Cost basis reporting was then included in the Senate version of the so-called tax extenders bill.[9] The Senate passed this bill, but it was rejected by the House when it passed its own extenders bill.[10] It was essentially resurrected less than one week later in an expanded version of the financial bailout bill that was passed by the Senate on October 1, 2008, after an earlier version of the bailout had failed in the House.[11]

The enactment of cost basis reporting after the solicitation of comments by the Senate Finance Committee in May of 2007 is significant. Earlier efforts to require broker reporting of cost basis likely died due to persuasive industry concerns regarding cost and complexity. In this latest cycle, the enactment of cost basis reporting indicates that such arguments were no longer persuasive. An important reason likely grew out of technological advances in computer and information systems. For example, even in 2006 a

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significant number of brokers were already using cost basis systems and providing related tax information to some, if not all, of their customers.[12]

Broker cost basis reporting is intended to promote tax simplification by reducing the basis related computations (such as corporate action related basis adjustments and wash sales) that an individual taxpayer would need to do in connection with a wide range of securities transactions. This burden is essentially shifted to brokers. Broker reporting to the IRS is also intended to reduce the so-called tax gap by reducing securities sales related mistakes and preventing intentional misstatements of cost basis. The IRS could use broker provided information on audit or possibly under information return based matching systems to make sure the correct amount of taxes are paid by investors relating to securities sales.

Required Reporting

New Code Sec. 6045(g)(2)(A) requires brokers to report on the gross proceeds information return for any "covered security" (as defined below) "… the customer's adjusted basis in such security and whether any gain or loss with respect to such security is long-term or short-term (within the meaning of section 1222)."[13]

Although the law is short and sweet, it is important to consider the potential adjustments to basis that could apply. The most significant are discussed later in this article. The applicable lot relief method is critical in determining the correct adjusted basis. Corporate actions and wash sales are also key in determining the adjusted basis of covered securities.

In addition, to determine whether gain or loss is long term or short term, brokers will need to determine the holding period for the covered securities. Lot relief methods, corporate actions and wash sales will affect that holding period. Also, other special rules affect the holding period of certain securities under various circumstances. The key holding period related issues are also addressed below.

Who Is a Broker?

Existing Reg. §1.6045-1(a)(1) defines a broker as "any person … that … stands ready to effect sales … made by others …," including a person that regularly retires its own debt or redeems its own stock ("effect" means either as agent or principal). This definition is broad and the regulation includes examples that can either explicitly or implicitly include the following persons depending on the facts: a mutual fund; a broker; a custodian; an escrow agent; and a stock transfer agent.[14]

Under this definition, it is possible that several persons could be characterized as a broker with regard to the same transaction. Multiple Form 1099s delivered for the same transaction would be confusing and could result in double-counting. To minimize this risk while still trying to make certain that at least one person is defined as broker, the regulations include a multiple broker exemption rule.[15]

In general, because the cost basis reporting law merely requires the gross proceeds reporting broker to provide additional information on a modified version of existing Form 1099-B, it may be a fair rule of thumb that those persons currently filing Form 1099-B will continue to do so, albeit with the required additional basis and short-term/long-term gain/loss information. However, the existing regulations do include examples of persons that could otherwise be classified as brokers that were excluded because they would not ordinarily know the gross proceeds from sales.[16] If the regulations were to require a similar analysis regarding whether a person had knowledge regarding cost basis or holding period of covered securities sold, it is possible that some persons classified as brokers required to file Form 1099-Bs today might not be treated as persons obligated to provide the additional cost basis information required by the new law.

Covered Securities and Effective Dates

The new cost basis reporting law uses some important terms of art to define the types of securities subject to cost basis reporting. Three important terms are "specified security," "covered security" and "applicable date."

New Code Sec. 6045(g)(3)(B) defines a "specified security" as "any share of stock in a corporation," "any note, bond, debenture or other evidence of indebtedness," "any commodity or contract or derivative with respect to such commodity" and "any other financial instrument" for which the IRS determines that adjusted basis reporting is appropriate. It should be noted that there is no exclusion for foreign securities in these definitions. Presumably, U.S. federal income tax law classifications of financial instruments as debt or equity, or entities as corporations, apply in interpreting the scope of this definition.

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One important distinction between the definition of specified security as enacted and earlier cost basis proposals suggested by the Treasury is that under the new cost basis reporting law there is also no exclusion for privately traded (rather than exchange traded) securities.

Note that the definition of specified security is not all encompassing. For example, it does not explicitly include broad categories of various types of financial derivatives such as swaps, caps and floors. However, a narrower grouping of commodity related derivatives would be included (along with possibly the related commodity contracts)—but only if the IRS issues regulations so providing. Also, one significant type of derivative is included—options, which are explicitly included pursuant to new Code Sec. 6045(h). And the new law does not explicitly include or address various derivative financial products sold currently in the markets that are packaged as investment units or as other forms of structured products. Even though such units and structured products are not explicitly addressed, it will likely be necessary to consider whether such units or products could be subject to basis reporting if they include a component that falls within the definition of a specified security.

Presumably, if the components of an investment unit are treated as separate items for federal income tax purposes, the effective date rules of the new law could apply to each component. Even routine transactions such as covered calls could raise concerns. For example, the stock component of a covered call could be subject to basis reporting based on when the stock is acquired while the call option would only be subject to basis reporting if acquired on or after January 1, 2013.

Many other types of existing financial products are also not addressed in the definition of specified security. It is reasonable to assume that certain types of financial instruments subject to existing types of IRS reporting such as hedge fund interests treated as partnership interests subject to K-1 reporting or trust certificates subject to widely held fixed investment trust (WHFIT) reporting were intentionally excluded from the definition of specified security because they are already subject to IRS reporting.

New Code Sec. 6045(g)(3)(A) defines a covered security as "any specified security acquired on or after the applicable date" if it was either (i) acquired through a transaction in the account in which it was held or (ii) was transferred to the account from another account and was a covered security in the other account, but only if the broker received a statement under Code Sec. 6045A with respect to the transfer. The "but only" language is significant because it technically relieves a broker of a cost basis reporting obligation if a transferring broker does not provide required cost basis information regarding the transferred security. The "covered security" reference in connection with transferred securities means that securities acquired pre-effective date don't become subject to cost basis reporting merely because they are transferred to a broker after the relevant effective date.

> Broker reporting of cost basis creates significant challenges for brokers.

Applicable date is defined in Code Sec. 6045(g)(3)(C) as January 1, 2011, for stock (other than mutual fund or dividend reinvestment plan—"DRIP" stock); January 1, 2012, for mutual fund and DRIP stock; and January 1, 2013, or such later date determined by the IRS in the case of any other specified security. Note that the applicable date definition forces brokers to sort specified securities into three types—regular stock; mutual fund and DRIP stock; and "other." This sort is necessary in order to determine the appropriate effective date for cost basis reporting for every specified security.[17]

Thus, the new law essentially forces brokers to create a matrix or grid comprising at least four security types—stock; mutual fund and DRIP stock; other covered securities; and excluded financial instruments; and at least three appropriate effective dates depending on the security type. This matrix could be even more complex if the IRS later subjects other financial instruments to cost basis reporting under its authority in Code Sec. 6045(g)(3)(B)(iii) or (iv) or creates multiple post–January 1, 2013, effective dates for various sub-types of "other securities" under its authority set forth in Code Sec. 6045(g)(3)(C)(iii).

This grid also generally applies in analyzing the effective date of the additional reporting provisions applicable to transferring brokers and issuers of covered securities under new Code Secs. 6045A and 6045B.[18] Cost basis reporting for options is subject to its own effective date relating to options granted or acquired on or after January 1, 2013.[19]

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Lot Relief Methods and Basis Averaging for Mutual Fund and DRIP Shares

Existing Law

To compute the adjusted basis of securities sold, the proper lot (or lots) of securities held by the customer must be determined. This process is often referred to as "lot relief." The applicable regulations under Code Sec. 1012 generally address the available lot relief methods for stock and other securities. Reg. §1.1012-1(c) sets forth lot relief method rules for sales of stock. Note that book-entry securities are addressed in a different section of the regulations (most, but not all, of investors' securities today are book-entry).[20] In general, the existing regulations permit the taxpayer to specifically identify the lot of securities being sold. However, if the taxpayer cannot identify the lot, the existing regulations (and the applicable case law) require the taxpayer to use the first-in/first-out method ("FIFO," treating the earliest purchased lots as sold first).[21]

A few important details regarding lot relief should be considered. First, a taxpayer can freely switch from one method of specifically identifying lots to another, or from specific identification to FIFO, or *vice versa*. A taxpayer can also use different lot relief methods for different securities. Second, specific identification ("specific ID") of lots permitted under the regulations has generally been interpreted as allowing taxpayers to use a wide range of methods or algorithms to select the specific tax lots to be deemed sold. Examples of some of the Specific ID methods used by taxpayers include highest-in/first-out (HIFO), last-in/first-out (LIFO), as well as a variety of so-called tax-efficient lot selection methods some of which are considered proprietary and for which patents have been applied or obtained. Third, the regulations specify and require a taxpayer instruction/broker confirmation procedure in order for the taxpayer to use a specific ID method.[22] Also, it should be noted that the existing regulations do not include explicit lot relief methods for a range of modern day securities other than stocks, bonds, mutual fund shares and certain investment units (examples of financial instruments not generally addressed include options, single stock futures and other derivatives).[23]

In general, taxpayers cannot use basis averaging of various tax lots for purposes of computing the basis of securities sold.[24] However, in connection with the growth of the mutual fund market and concerns regarding the complexities for mutual fund brokers and customers in the computation of basis for mutual fund shares in light of dividend reinvestment and recurring purchases of additional shares, the IRS issued regulations permitting taxpayers to elect basis averaging for such shares in 1971.[25] Reg. §1.1012-1(e) sets forth the rules for averaging.[26] There are two permitted methods for averaging—single category and double category averaging.[27]

The election must be made by the taxpayer on the first tax return for the year the method is to be effective.[28] A designation that the taxpayer has elected averaging is generally made on Schedule D.[29] The taxpayer is required to maintain all records necessary to substantiate his or her computation of averaging.[30] The election applies to all shares of the mutual fund for which the election is made (but not to shares of other mutual funds including funds that are part of the same fund complex), beginning with any shares acquired at any time during the tax year for which the election is made.[31] The election is irrevocable once made, and can only be revoked with the written consent of the IRS.[32]

In double category averaging, there are separate averaging pools for lots that have been held for the short-term gain/loss holding period and for lots that have been held for the long-term gain/loss holding period.[33] The details of the double category method are somewhat complex. The method permits the taxpayer to specify to the custodian or agent whether lots are selected from the short-term or the long-term pool when shares are sold.[34] Otherwise, lots are first selected from the long-term pool. Once lots in a particular pool are exhausted, lots are selected from the remaining pool. The holding period of lots within the short-term pool must be tracked because once a lot has been held for more than one year, it is moved from the short-term pool to the long-term pool.[35] The basis of the lot so moved is the average basis based on all of the shares in the short-term pool.[36] If some but not all of the shares in the long-term pool are deemed sold, the regulations require that the lots treated as sold must be the oldest (the earliest acquired).[37] The regulations also include special wash sale related rules applicable to lot relief under the double category averaging method.[38]

Because of comments received by the IRS when proposed regulations to permit averaging were published, the final regulations added the single category averaging method.[39] Under the single category method, a single pool is maintained and an average

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basis is maintained that is computed for each share as "… an amount equal to the remaining aggregate cost or other basis of all shares in such account … divided by the aggregate number of shares in such account at such time."[40] Shares within the pool that are deemed sold upon the disposition of shares are the first acquired (the oldest lots). It is necessary to maintain the holding period information for all of the lots within the pool because once all of the lots with a holding period of more than one year are exhausted, the taxpayer must treat any short-term lots as disposed and report short-term capital gain or loss with respect to such lots.[41] The regulations also provide that the single category method cannot be used if it appears, based on the facts and circumstances, that one purpose for using such method is to convert short-term gains and losses to long-term or *vice versa*.[42] The regulations also specify that the wash sale rules apply to shares under the single category averaging method.[43]

The Cost Basis Reporting Law

The new cost basis reporting law generally provides that adjusted basis is determined "in accordance with the FIFO method unless the customer notifies the broker by means of making an adequate identification of the stock sold or transferred …"[44]

Note that the law creates both a default rule and an exception. The FIFO method is the default. Other lot relief methods (all derived from the adequate identification method reference) are available only if the customer notifies the broker that he or she wants to use a method besides FIFO. Thus, brokers will generally need to provide for FIFO default, respond to customer notifications, and provide lot relief based on the method selected by the customer. As a result, brokers systems will need to support multiple lot relief methods. There may also be concerns regarding whether customer notifications and broker confirmations comply with the existing regulations because there is no indication that the new law relaxes these requirements.

The new law includes an important detail regarding the calculation of lot relief. It provides that the lot relief methods are applied on an account by account basis.[45] This permits a broker to calculate lot relief based on only the lots within each specific account, rather than forcing the broker to determine whether the taxpayer holds other accounts that contain the same securities and obtain the lot information for such securities.

In the case of mutual fund and DRIP shares, the law provides that the broker selects the default method of lot relief (which could be a permitted average basis method rather than FIFO, for example) "… unless the customer notifies the broker that he elects another acceptable method … ."[46] A staff explanation of an earlier version of the cost basis legislation clarified that it was intended that the broker can make the election on an account by account and on a customer by customer basis (electing averaging, FIFO, or one of various specific ID methods for each customer).[47] Because the customer can elect another method, it appears that brokers systems for mutual fund and DRIP shares will also generally need to support multiple lot relief methods for each customer.

Some important details that are unclear regarding averaging relate to the taxpayer election. Under the existing regulations, the taxpayer rather than the broker elects averaging and makes the election on his or her tax return. Because the broker makes the election under the new law, presumably the broker must instruct its customer (the taxpayer) to reference the election on his or her tax return. What are the consequences if the taxpayer does not do so? Also, who is the "broker" for this purpose and how is the election made? If a customer has mutual fund or DRIP shares in multiple accounts with a broker, can the broker elect different methods for each account (averaging for one account and not for another)? Given that the election is available for both mutual funds and DRIP shares and can be applied at a customer by customer level for each fund or DRIP, these details could be complex. Presumably, in light of the wording of this new rule, a taxpayer can elect out of averaging. This is not the case under the existing regulation. Must the election out be made in the initial year or can it be made later?

As discussed earlier, cost basis reporting generally only applies to shares acquired on or after the applicable date.[48] Under averaging, brokers would generally need to compute and maintain two pools of average basis shares for each of its customers that hold mutual fund or DRIP shares—a pool of pre-effective date (grandfathered) shares and a pool of shares subject to basis reporting (covered shares). The new law permits funds and brokers to make a so-called single account election to aggregate all of the shares and maintain only one averaging pool for each customer.[49] This election is made by the fund, nominee broker or DRIP broker and there will be technical questions regarding how the election is made (and whether it is the same person as the person who elects the lot relief method, particularly given that the terminology is slightly different

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in the two provisions). One significant downside of making the election is that for many funds (and probably brokers of DRIP shares) the lot information for existing shares may be weak or unclear. There are concerns regarding the penalty risk of using such information in completing information returns. Thus, many may be carefully weighing the reduced complexity of making the single account election against this penalty risk.

Adjustments for Corporate Actions

Stocks and securities are routinely subject to a variety of corporate actions. Corporate actions include corporate name changes, stock splits and stock dividends, reverse splits, stock redemptions and tender offers, corporate mergers, spin-offs and bankruptcy reorganizations. Corporate actions can affect the name, number of shares or amount of securities held. Corporate actions can affect basis and holding period of stocks and securities held and can trigger recognition of gain, loss or ordinary income.

Properly adjusting the basis and holding period of stock and securities positions can be complex. Improper adjustments can result in errors that can adversely affect computations of taxable gain or loss. Individuals may have a difficult time tracking these adjustments.[50] Banks, brokers and other portfolio managers typically rely on corporate action reporting services to track them.[51] However, corporate action reporting services do not necessarily track all corporate actions.[52] Moreover, in many cases, the issuer of covered securities does not provide a U.S. tax opinion regarding the tax consequences of the corporate action to holders of its securities. In other cases, the issuer's tax opinion may be unclear, confusing or present two or more alternate tax characterizations with no clear guidance regarding the likelihood of any of the outcomes.

Because the cost basis reporting law requires brokers to report adjusted basis, it is clear that they are responsible for corporate action related basis adjustments to covered securities. This is necessary to achieve the goal of reducing tax complexity facing individuals when they report gains and losses from covered securities on Form 1040, Schedule D. In order to provide brokers with the information necessary to make such basis adjustments, the cost basis reporting law includes the new Code Sec. 6045B, which requires issuers of specified securities to make a return describing the corporate action and "the quantitative effect on the basis of such security resulting from such action …" and to file the return with the IRS and furnish statements to holders or nominees.[53] This new issuer corporate action statement requirement is discussed below.

One important consideration for brokers is that their obligation to report adjusted basis is not directly dependent on issuer corporate action reporting. In other words, under the letter of the law a broker is obligated to report adjusted basis with respect to a covered security regardless of whether the issuer of the security properly reports on a corporate action as required by new Code Sec. 6045B.[54] This risk could be significant for several different types of securities: small thinly traded companies that may not have the resources to properly report; foreign issuers that may not be concerned regarding U.S. tax consequences or subject to U.S. jurisdiction; and simple and complex derivatives for which the tax law consequences of corporate actions may not yet be clear or widely known. In addition, it is yet to be determined how issuers of covered securities will provide the quantitative effect on basis of corporate actions in those cases where the consequences are unclear or where alternative outcomes are possible. The cost basis reporting law does not revise or simplify existing U.S. corporate tax law. Thus, it is possible there may still be cases where the broker must determine the impact of corporate actions on the adjusted basis of covered securities.

Another concern relates to broker accuracy in adjusting basis for corporate actions. It appears that currently brokers take a wide range of approaches in determining the tax consequences of corporate actions and often use simplifying assumptions such as all stock mergers are tax-free. But even a transaction that is essentially a tax-free reorganization can be partially taxable when holders of securities receive stock and cash or can select differing amounts of consideration. It is not clear whether such complexities are completely addressed by brokers currently. However, under the cost basis reporting law, brokers will be subject to penalties (discussed below) for incorrect, adjusted basis information reported on Form 1099s. Moreover, the reporting of corporate action information under new Code Sec. 6045B and reporting of adjusted basis information on Form 1099s should permit the IRS to determine whether brokers are accurately reporting basis adjustments. These factors should cause brokers to more accurately track corporate action related basis adjustments, resulting in the elimination of simplistic approaches. Unfortunately, the cost of so doing could be burdensome.

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Return of Capital

One specific type of corporate action related basis adjustment that relates to corporate distributions is return of capital (ROC). Under Code Sec. 301, distributions by a corporation to its shareholders are only dividends to the extent of the corporation's current and accumulated earnings and profits. Distributions in excess thereof are treated as ROC but only to the extent of the holder's basis in the related stock.[55] The holder's basis in the related stock is reduced by the amount of the ROC received during the year.

Many real estate investment trusts (REITs) regularly make monthly distributions that include a ROC component. In January, REITs typically provide their shareholders with a statement regarding the character of distributions received during the prior calendar year, including whether any ROC was distributed. Holders need to adjust their basis in their shares accordingly. The ROC adjustments are retroactively prorated to each distribution or allocated to specific distributions paid during the prior year based on whether the company had current and/or accumulated earnings and profits.[56] These basis adjustments could affect both the computation of gain or loss for ROC affected shares sold during the prior tax year or the basis of shares that the investor still holds.

ROC concerns can arise with covered securities other than REIT shares. For example, newly formed corporations may have little, if any, earnings and profits. Many natural resource companies have little earnings and profits. Similar issues also exist for non-U.S. real estate companies such as Canadian real estate trusts.

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The new cost basis reporting law will force brokers to address ROC related basis adjustments. The retroactive nature of the adjustments could be vexing from a systems perspective.

Commissions and Loads

In computing gain or loss, a taxpayer generally takes into account the commission paid for a security by including the amount in his or her adjusted basis of the security sold.[57] In the case of mutual fund shares, such upfront fees are often referred to as "front-end loads." Some mutual funds are considered "no-load" funds because they do not charge an upfront fee. Instead, they often use a so-called 12b-1 plan to recover marketing related expenses from their holders on an ongoing basis. Another alternative to front-end loads offered by some mutual funds are deferred or "back-end" loads (often referred to as a contingent deferred sales commission—CDSC) that are only paid if the holder disposes of his or her shares within a specified period after the shares were purchased (such as five years). As a technical matter, the load is imposed on an identified class of mutual fund shares. Once an investor has held the shares for the requisite period, his or her shares are converted from that class of shares to another class of shares of the same fund (that are not subject to the load charge or CDSC). Mutual fund complexes often offer investors the right to exchange shares in one fund with shares in another without incurring additional load charges. These varying methods of paying commissions and other costs, along with the related separate classes of mutual fund shares that exist, can raise a series of concerns regarding the related shares.[58]

The imposition of back-end load or CDSC charges on disposition of certain mutual fund shares could raise mechanical issues for brokers in complying with the cost basis reporting requirement.

Wash Sales

The wash sale rule of Code Sec. 1091 routinely results in deferrals of realized losses on the disposition of securities by investors. Under the general rule, a loss realized on the disposition of a stock or security is deferred if the taxpayer acquires (or has entered into a contract to acquire) "substantially identical stock or securities" within a 61-day period beginning 30 days before the date of such disposition and ending 30 days after such date.[59] The stock or securities acquired during this 61-day period that result in a wash sale deferral are referred to as the "triggering securities."

Because the wash sale rule is generally only triggered if acquisitions or contracts to acquire securities occur during the 61-day period, it is often believed that the rule can be relatively easily avoided. In practice, however, active trading by investors, traders and portfolio managers regularly triggers the rule.

Because the wash sale rule is intended as a deferral rule rather than a permanent disallowance rule, a loss deferred under the rule is generally ultimately recognized upon the subsequent disposition of the triggering securities. Significantly, Code Sec. 1091(d) requires a basis adjustment to the triggering securities when they are disposed—the amount of the adjustment equals the related previously deferred wash sale loss.[60] There is also an adjustment to the holding period of the triggering securities that takes into account the holding period of the securities that were subject to the related wash sale deferral.[61]

There are a range of dimensional complexities relating to wash sales. A discussion of them is generally beyond the scope of this article. However, because wash sale deferrals affect the reporting of recognized gains and losses on the disposition of covered securities and the adjusted basis of the related triggering securities, a threshold issue for Congress in crafting the cost basis reporting law was whether brokers would be required to take into account wash sales in computing the adjusted basis and short-term/long-term gain or loss information subject to basis reporting. There was commentary on this issue from various groups and industry organizations and dialogue with congressional staffs.[62] The cost and complexities of wash sale related adjustments for brokers were likely weighed against the existence of software systems that adjust for wash sales and the simplification and tax gap benefits of requiring such reporting.

The cost basis reporting law settles this question and requires brokers to take into account wash sales in determining a customer's adjusted basis in covered securities, subject to two key simplifying assumptions.[63] First, brokers are only required to apply the wash sale rule with respect to identical securities rather than substantially identical securities. This simplifying assumption eliminates a key dimensional complexity of the rule relating to the determination of under what circumstances a different security is substantially identical to another for purposes of the wash sale rule. Congressional staff explanations have made reference to the use of CUSIP identifying numbers used for many stocks and securities as a method of determining whether securities are identical for this purpose.[64] There are still open questions regarding whether securities are identical, however. For example, what method will be used for securities that do not use CUSIPs, such as options (where the same ticker symbol can over time refer to several different options) or foreign securities that use SEDOL or other types of identifiers?[65] Also, what about different classes of stock that have different CUSIPs but are close to identical? It is also not clear how the identical security simplifying assumption will be applied in the case of wash sales that occur when a corporate action (such as a tax-free merger or even a corporate name or security CUSIP change) transforms one security into another. These sorts of questions will hopefully be addressed in future IRS guidance.

The second significant simplifying assumption is that brokers must only compute wash sale adjustments for transactions that occur within the same account. This assumption makes the processing simpler, even in cases where multiple accounts are held with the same broker for a single taxpayer. It also makes sense to not require a broker to take into account "held away" assets that are not in the broker's systems or within the broker's knowledge in computing wash sales.

Brokers should note that the cost basis reporting law provides that the IRS has the regulatory authority to modify or eliminate these two assumptions.[66] Thus, the IRS could take away either of these assumptions if it believes there is abuse. For example, it has been noted that wash sale adjusted reporting can be avoided by simply maintaining multiple accounts and carefully managing trading activities to avoid wash sale triggering purchases in the same account as loss generating transactions. It would not be surprising for the IRS to take action if it became aware of widespread abuses based on such suggestions.[67]

Note that these simplifying assumptions only apply for purposes of broker cost basis reporting. The new law does not amend or revise any part of the wash sale rule of Code Sec. 1091. Thus, taxpayers and their advisors are still required to compute wash sales under existing law. It is likely that there will be differences in basis, holding period and deferral computations because of the differences in the simplified method for computing wash sales applicable to brokers for cost basis reporting purposes and the regular method applicable to taxpayers. This could lead to Form 1099-B basis related–reconciliation issues that may be much more complex than those arising currently for reconciling gross proceeds reported to amounts realized on Schedule D. It would not be surprising that such reconciliation related concerns could become important for brokers, as a customer service, tax return preparers, due to penalty risks, and the IRS, in connection with taxpayer audits and analytics.

One important mechanical complexity relating to the wash sale rule that must be discussed relates to how the rule is applied when the quantity of securities sold at a loss differs from the quantity of triggering securities acquired. The applicable regulations provide general guidance on this issue.[68] Although the computational details can be very complex, the rule essentially requires the taxpayer to often subdivide an existing tax lot of stocks or securities into two or more portions—or "sublots," so that the quantities of securities sold at a loss matches the amount of the wash sale triggering securities acquired. The remaining separate sublots must be tracked so that subsequent sales or acquisitions that either trigger additional wash sales or result in basis

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and holding period adjustments when securities are subsequently sold are properly applied. These rules are mechanical and there are software systems that adjust for wash sales taking into account this detail.

Short Sales

Short selling is generally a routine type of transaction involving securities. A short sale involves the sale of securities today that the short seller does not deliver on the short sale date (the "trade" or "open" date). Instead, the short seller delivers the identified securities on a later specified date (the "delivery" or "close" date). The seller's broker typically lends the short seller the securities needed to execute the short sale on the trade date. The seller generally receives proceeds from the short sale on the trade date. However, other than in the case of short sales that trigger constructive sales under Code Sec. 1259, short sales are not generally taxed until the delivery date. This is because the short seller's gain or loss on the short sale cannot generally be determined at the time the short sale is opened since the basis of the securities delivered by the short seller are potentially unknown until the short seller delivers the securities used to close the short sale on the delivery date.

Short sales gross proceeds are currently reported by brokers on Form 1099-B.[69] Short sales are reported on Form 1099-B at the time (and in the calendar year) the short sale is opened. Taxpayers generally need to make adjustments for short sales opened and closed during the calendar year and in the prior year in reconciling the total amount of gross proceeds reported on Form 1099-Bs with the amount of gains realized during the current calendar year.

Because the adjusted basis of the securities used to close a short sale may not be known at the time a short sale is opened, the cost basis reporting law changes the timing of when short sales are reported on Form 1099-B. Under new Code Sec. 6045(g)(5), reporting will now be made in the calendar year the short sale is closed (rather than in the calendar year the short sale is opened).

Short sales are subject to special holding period rules under Code Sec. 1233 that can affect the determination of whether short sale gains and losses are long term or short term.

Short sales are also subject to special wash sale rules that can result in loss deferrals and basis and holding period adjustments to triggering securities. First, if a short sale is closed at a loss and the taxpayer acquires substantially identical securities within the 61-day period, a wash sale can be triggered under the basis rule of Code Sec. 1091(a). Second, the short sale rule includes a special provision that applies when a short sale is closed at a loss and a new short sale is entered into with the 61-day period. And, Reg. §1.1091-1(g) includes another special short sale rule that changes the applicable centering date around which the 61-day period is computed.

Options

It is significant that the cost basis reporting law requires information reporting with respect to options on specified securities. Under the existing definition of a security subject to gross proceeds reporting set forth in Reg. §1.6045-1(b)(3), an option on a security is not included and is explicitly excluded from the sub-definition of an "interest in a security." The exclusion of options reporting under existing law may have been justified for various reasons. However, it is worth noting that the options market has continued to grow over the years as both sophisticated investors such as hedge funds and individuals have entered into more and more options positions.

Under new Code Sec. 6045(h), both options transactions relating to covered securities that involve physical settlement of the option and cash settled options transactions (which do not directly involve the underlying security) relating to specified securities are subject to cost basis reporting. Thus, brokers will need to develop both gross proceeds reporting systems and adjusted basis and short-term/long-term gain/loss calculating systems to properly comply with the new law. This could be a significant challenge for many brokers, which is why the effective date for options reporting under the new cost basis law (including gross proceeds reporting) is with respect to options granted or acquired on or after January 1, 2013.[70]

Brokers will need to familiarize themselves with the tax law rules relating to options acquisition, settlement, lapse and exercise in order to make the proper basis and holding period adjustments for complying with the new law.[71] They will also need to consider the impact of corporate actions on underlying securities as they affect options for reasons comparable to that relating to the underlying securities themselves. Moreover, although the wash sale rule simplifications would appear to clearly exclude broker reporting or basis adjustments in connection with wash sales arising between positions in underlying covered securities and related options

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(because such positions would not be identical), the wash sale rule could apply in connection with the disposition of an option at a loss and the acquisition of a substantially identical option.[72] Thus, brokers will likely need to assess whether one option is identical to another (rather than merely substantially identical) under the simplified wash sale rule referenced in Code Sec. 6045(g)(2)(B)(ii) and if so, make the necessary basis and holding period adjustments.

Debt Securities

A number of mechanical issues relate to the computation of adjusted basis with respect to debt securities. For example, some debt securities are issued with original issue discount (OID). OID must be accrued and is generally included in taxable income by holders on a daily basis.[73] Accrued OID results in a basis adjustment to the related debt instrument pursuant to Code Sec. 1272(d)(2). OID is generally accrued on a constant interest rate basis that takes into account compounding of interest.[74] However, each taxpayer has great flexibility in the details of OID calculation and can generally select their own accrual periods, ranging from one day to not more than one year.[75] Such taxpayer flexibility could be problematic for brokers attempting to calculate OID.

In addition, Code Sec. 1272(a)(7) provides for a reduction in OID accruals in cases where the purchaser pays an "acquisition premium" and acquires the OID debt instrument at a price greater than its adjusted issue price.[76] Thus, brokers will need to be able to determine whether a debt security has been purchased with acquisition premium and must be able to correctly compute the related adjustment in order to compute the OID accruals and basis adjustments correctly for different OID debt instruments held by different taxpayers.

Different OID rules apply to different types of debt instruments. For example, mortgage-backed and certain other debt securities subject to prepayment are subject to a different OID accrual method specified under Code Sec. 1272(a)(6) that relies on a prepayment assumption. Debt instruments that provide for contingent payments are subject to another set of OID rules under Reg. §1.1275-4. So are variable rate debt instruments, municipal bonds, inflation indexed securities and Treasury securities and other short-term instruments.[77] It will be necessary to develop systems to properly sort debt instruments into these various classifications and apply the special rules applicable to each of them in order to properly compute their adjusted basis.

Complexities arise when bonds are purchased at a market discount or a bond premium. The Code has rules generally permitting taxpayers to elect to amortize bond premium and also permitting the accrual and inclusion of market discount income.[78] These elections also affect the adjusted basis of the related debt instruments.[79] There are differences or uncertainties in the application of some of these rules to certain types of bonds.[80] Although these rules are mechanical, brokers systems will need to properly sort debt securities and apply these applicable premium and market discount rules as well on a taxpayer-by-taxpayer and security-by-security basis in order to compute adjusted basis.

For these reasons, the effective date for broker basis reporting with respect to debt instruments is delayed and only applies to debt acquired on or after January 1, 2013.[81] However, given the technical issues identified above that impact the computation of adjusted basis of debt, brokers would be advised to begin preparing for these types of securities soon.[82]

Customer Account Transfer Reporting by Brokers

An important component of the cost basis reporting schema is the required transfer of cost basis related information from one broker to another when a customer transfers his or her account and its related investments to a new broker. The required reporting of such information is set forth in new Code Sec. 6045A (the "broker transfer rules"). As noted earlier in the section regarding effective dates, the "but only if" language of Code Sec. 6045(g)(3)(A)(ii) excludes securities from the definition of covered securities subject to basis reporting if they were transferred to the broker and the required Code Sec. 6045A statement was not received. Note that the broker transfer rules require a statement to be provided to the recipient broker—not a return that must be filed with the IRS.

Probably the most important aspect of the broker transfer rules is the deadline for delivering the statement to the receiving broker. Under Code Sec. 6045A(c), except as otherwise provided by the IRS, the required statement must be furnished to the receiving broker no later than 15 days after the date of the securities transfer. This 15-day delivery requirement makes logical sense because the receiving broker needs the information quickly to permit it to meet its basis reporting requirement due to potential post-transfer wash sales and corporate actions. If the receiving broker did not obtain information regarding transferred securities until much later, it is possible that a series of retroactive ad-

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justments would need to be made due to intervening transactions and events. This could prove burdensome to the receiving broker's basis tracking system.

It is also important to note that the broker transfer requirement essentially becomes effective 15 days after the first applicable date for each type of covered security. In other words, stock acquired on or after January 1, 2011, is a covered security. If a customer opens an account with broker A, purchases stock in the account on January 1, 2011, and then at the end of the day transfers the account to broker B, broker A would be obligated to deliver the required statement to broker B no later than January 16, 2011. This makes structural sense in order to permit broker B to report basis information relating to the January 1, 2011, stock purchase if the customer sells the position during calendar year 2011.

Another key aspect of the broker transfer rules is that the scope of applicable persons required to comply with its reporting requirements is broader than the term broker under Code Sec. 6045. Code Sec. 6045A(b) defines "applicable person" as any broker (as defined earlier) and any other person as provided by the IRS in regulations. Such other persons could include persons in various positions within the securities industry as well as possibly individuals or trustees that transfer physically held securities to brokers and transform the holdings to book-entry. The potential inclusion of other persons appears well thought out because a number of persons may have knowledge of original cost and holding date information for specified securities even though they do not fall within the definition of a broker.

The one element of the broker transfer rules causing the most concern relates to uncertainty regarding the type of transferred securities information that must be reported to the receiving broker. Unfortunately, this important detail is not clearly set out. Instead, Code Sec. 6045A(a) provides that the reporting statement shall set forth such information as the IRS may by regulations prescribe. Thus, brokers and their systems providers must wait for IRS guidance on this critical detail.

As a general matter, a statement that merely included the current adjusted basis and holding period information for transferred positions could be inadequate. Prior wash sales, corporate actions, lot relief methods and elections, dividend reinvestments, short sales, options and various debt security related taxpayer elections and securities information may all include important elements that could be significant in determining the adjusted basis and holding period of a transferred security subsequent to its transfer to another broker. These details readily explain why Congress left the task to the IRS.

It is expected that the statements delivered to provide the information required by Code Sec. 6045A will typically be sent electronically. It should be noted that the Depository Trust and Clearing Corporation (DTCC), as service provider to the securities industry, offers an automated customer account transfer service (ACATS) and a related cost-basis reporting service (CBRS). Many have assumed that these services will be used to provide the required tax information.

Corporate Action Reporting by Issuers

The cost basis reporting law also requires issuers of specified securities to file a new type of tax return regarding corporate actions to the IRS and to provide related statements to holders. Code Sec. 6045B(a) requires an issuer of a specified security to make a return that includes a description of "any organizational action which affects the basis …" of a specified security, the "quantitative effect on the basis of such specified security resulting from such action," and such other information as the IRS may require. This is also a necessary part of the schema for broker basis reporting because corporate action information is vital for properly computing adjusted basis and current tax law does not require issuers to report such information to holders with specificity.

Requiring an issuer of a specified security to report on the quantitative effect of a corporate action on basis sounds like a neat trick, but it may have its limitations. The basis reporting law does not address or change any existing tax law rules regarding the tax consequences of various types of corporate actions. Thus, as is currently the case, there may be a number of corporate actions where the quantitative effect on basis is unclear. Essentially, brokers will still be required to take a position regarding the impact of any such actions in order to report adjusted basis.

Code Sec. 6045(b) requires that such returns be filed no later than the earlier of 45 days after the date of the corporate action or January 15 of the following calendar year. Code Sec. 6045(c) obligates the issuer to provide the nominees of holders of the specified securities (or the certificate holder if there is no nominee) a written statement showing the information set forth above, issuer contact information and such other information

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as the IRS may require. The written statement must be delivered to the nominee (or the holder) on or before January 15 of the following calendar year. Because the issuer is not obligated to deliver the written statement to nominees or holders until January 15 of the following calendar year, such delayed delivery in the calendar year after the corporate action has occurred could prove problematic for most brokers. In order to keep adjusted basis updated (including for transfers of accounts to other brokers), brokers will look to make corporate action related adjustments on a daily basis. They already feel compelled to do so and would appear likely to continue to do so in connection with basis reporting. Retroactive adjustments could be triggered if the information provided on the issuer statement the following year is inconsistent with the adjustments made by the broker. It is also possible that there could be logistical issues in transferring the information received by nominees or holders to the reporting broker.

Congress was sensitive to the need to provide the information quickly and readily. Code Sec. 6045B(e) provides that the IRS may waive the IRS return and holder statement requirements if the issuer makes the required information publicly available in a format to be determined by the IRS. Such a public repository (or multiple repository) system makes sense and could facilitate the rapid electronic transfer of the needed information to brokers to hopefully prevent or minimize the retroactive adjustment concern discussed above.

As noted earlier in the discussion regarding corporate actions, a broker's obligation to properly report adjusted basis is not dependent on whether the broker has received the corporate actions information that issuers are required to provide under Code Sec. 6045B. It is possible that issuers of some covered securities may not provide the required statements. Thus, for both the daily processing reason discussed above, as well as for providing for corporate action adjustments in those cases where a corporate action issuer statement is not received, brokers will likely need to maintain their existing systems to account for corporate actions on customer securities.

Other Basis Adjustments

The new cost basis law does not explicitly address other basis and character of gain or loss adjustments that can routinely occur with respect to securities. The cost basis reporting law is silent on whether brokers will be responsible for making any of these other adjustments. Brokers will likely hope or presume that future IRS guidance will clarify that such other adjustments need not be taken into account in computing adjusted basis for broker basis reporting. However, brokers will likely still consider whether such adjustments should be made (whether or not reported on Form 1099-B) and provided to customers as a customer service. Examples of such adjustments are those that are gift related under Code Sec. 1015, death related under Code Sec. 1014 (and possibly Code Sec. 1022), mutual fund and REIT gain distribution related under Code Secs. 852(b)(4) and 857(b)(8), and mutual fund load related under Code Sec. 852(f).[83] Also, because the wash sale rule is explicitly addressed under the new basis reporting law (while there is no reference to these other rules), it is presumed that brokers are not required to report any gain/loss and holding period adjustments related to other more complex income tax rules applicable to securities such as the straddle rule of Code Sec. 1092 and the constructive sale rule of Code Sec. 1259.

S Corporations

Reg. §1.6045-1(c)(3)(i)(A) exempts brokers from having to file Form 1099-B with respect to "exempt recipients." The definition of exempt recipient excludes corporations.[84] Because S corporations are a type of corporation for tax purposes, there is no current Form 1099-B reporting to S corporations.

Under the cost basis reporting law, brokers will be required to file Form 1099-Bs for sales of covered securities acquired by S corporations (other than financial institutions) after December 31, 2011.[85] Thus, brokers will need to determine whether corporate holders of securities are S corporations so that they can provide them with Form 1099-Bs after this effective date. Unfortunately, there is no easy way for brokers to determine whether a corporation is an S corporation.

Change in Filing Due Date for Statements Provided to Customers

Under present law, a copy of Form 1099-B must be provided by a broker to customers no later than January 31 of the following calendar year.[86] The cost basis reporting law extends this deadline to February 15, beginning with statements due in calendar 2009.[87]

The industry had requested such a deadline extension and it is particularly relevant given that the

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new cost basis reporting law requires brokers to adjust basis for wash sales. Because of the 61-day wash sale period, a purchase occurring on January 30 (30 days after) a sale at a loss on December 31 of the prior calendar year could trigger a loss deferral under the wash sale rule that would result in a reporting adjustment for the prior calendar year. This extension gives brokers a little more time to take into account such adjustments.

The extension to February 15 applies to basic gross proceeds reporting under Code Sec. 6045(b) as well as statements relating to substitute payments in connection with short sales under Code Sec. 6045(d).[88] It also applies to a "consolidated reporting statement (as defined in regulations) …"[89] Because of the benefit of the deadline extension, there will likely be significant inquiry by brokers regarding the scope of the extension for consolidated reporting statements and whether various types of statements so qualify.

Potential Penalties

Current law imposes penalties for late or incorrect Form 1099s.[90] Because the cost basis reporting law merely adds additional information to existing broker reporting requirements, such penalties could be imposed if brokers fail to provide the required adjusted basis and short-term/long-term gain/loss information or if the information is incorrect. The new broker transfer reporting requirement and the new corporate action information reporting requirement are also subject to these penalties.[91]

Conclusion

As is apparent from the discussion set forth above, the new cost basis reporting law will impose substantial burdens and raise new challenges for brokers in complying with securities related tax reporting. Brokers, as well as their vendors and advisors, will be awaiting the needed IRS guidance relating to key details of the new rules, particularly with regard to which securities will be treated as DRIP shares, the mechanics of the averaging related elections, issuer corporate action reporting and the information that transferring brokers must provide in connection with account transfers. As investors receive the additional basis related information on Form 1099-Bs and process it, they may begin to ask brokers to change their lot relief methods or to provide them with basis information regarding pre-effective date holdings (even though such holdings are not subject to basis reporting). The IRS will need to develop methods to verify the broker provided information and reconcile it with the information taxpayers report on Schedule D (particularly given that the rules applicable to taxpayers are more complex), as well as methods of verifying the accuracy of brokers' calculations. Given all of this work, hopefully the goals of simplification for individual filers and reduction of the tax gap will be achieved.

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Endnotes

* Disclosure: GainsKeeper and Wolters Kluwer Financial Services could benefit from the broker basis reporting law.

1 Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

2 Division B, Act Sec. 403 of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

3 *See generally* Internal Revenue Code (Code) Sec. 6045 and related regulations.

4 *See* background discussion set forth in Conlon, *Broker Basis Reporting Proposed Legislation: Simplification by Decree—Details to Come,* 6 J. Tax'n Fin'l Products 4 (Sept. 2007).

5 On May 25, 2007, the staff of the Senate Finance Committee released a draft cost basis reporting proposal, along with a technical explanation prepared by the Joint Committee on Taxation and solicited public comment with a deadline of June 30, 2007. Comments were received and posted on the Senate Finance Committee Web site.

6 Cost basis reporting was included in H.R. 6, the Clean Renewable Energy and Conservation Tax Act of 2007, and H.R. 3996, the Temporary Tax Relief Act of 2007, both of which were passed by the U.S. House of Representatives in November and December, 2007.

7 *Compare* H.R. 3221 as passed by the U.S. House of Representatives on May 8, 2008, with H.R. 3221, the Housing Assistance Act of 2008, P.L. 110-289, as enacted on July 30, 2008.

8 *Compare* Act Sec. 403 with Section 641 of H.R. 3221 as passed by the U.S. House of Representatives on May 8, 2008. The notable changes are to effective dates and the expansion of mutual fund averaging from only open-end mutual funds in H.R. 3221 to any mutual fund in the Act.

9 H.R. 6049, the Energy Improvement and Extension Act of 2008, as passed by the U.S. Senate on September 23, 2008.

10 H.R. 7060, the Renewable Energy and Job Creation Tax Act of 2008, passed by the U.S. House of Representatives on September 26, 2008.

11 H.R. 1424, the Emergency Economic Stabilization Act of 2008.

12 *See* introductory remarks of Sen. Bayh (Indiana) in connection with the introduction on March 14, 2006, along with Senators Obama, Carper, Kerry and Levin, of S. 2414, the Simplification Through Additional Reporting Tax Act (the "START Act") that "[i]f Fidelity or Ameritrade or E*Trade can provide cost basis information to all of their clients, it clearly suggests that the information can be provided."

13 The statutory reference to merely having the return indicate whether gain or loss is long term or short term was intended to reduce unnecessary detail from reporting—such as the holding period of all the various tax lots that might underlie a single sales transaction reported on Form 1099-B. Of course, there are various circumstances where gain or loss

ENDNOTES

could be part long-term and short-term. *See, e.g.,* Code Sec. 852(b)(4). There are other circumstances, such as the disposition of debt instruments at a market discount or the disposition of nonfunctional currency denominated debt instruments, where gain or loss could be part capital and part ordinary due to Code Sec. 1281 or Code Sec. 988.

[14] Reg. §1.6045-1(b), Example 1. *But compare* with Example 2, which includes examples of similar persons not treated as brokers due to different facts.

[15] Reg. §1.6045-1(c)(3)(iii). Note that the person initiating the sale must be a specified type of exempt recipient as referenced therein.

[16] *See* Reg. §1.6045-1(b), Example 2(i) and (v).

[17] Note that the sort between regular stock and mutual fund and DRIP stock should logically be determined before the applicable date for stock, January 1, 2011. Otherwise, a broker could fail to apply the applicable date rules appropriately. A potentially difficult issue relating to DRIP stock is under what circumstances a stock will be considered DRIP stock. For example, if broker A offers a DRIP plan but broker B does not, is the stock DRIP stock in the hands of broker A but not broker B? Also, does DRIP classification depend on whether a DRIP plan is offered or actually elected by the stockholder? If a DRIP plan begins or is terminated, is the related stock transformed from regular stock to DRIP stock (or *vice versa*)? The same concerns are relevant for determining the eligibility of the averaging election. Hopefully the IRS will issue timely guidance on these sorts of issues.

[18] *See* references to covered securities set forth in Code Sec. 6045A and references to covered securities and applicable date set forth in Code Sec. 6045B(d).

[19] Code Sec. 6045(h)(3).

[20] Reg. §1.1012-1(c)(7).

[21] Reg. §1.1012-1(c)(1).

[22] *See* Reg. §1.1012-1(c)(2), (3) and (7). *See also* Rev. Rul. 61-97, 1961-1 CB 394, *clarified by* Announcement 61-77, IRB 1961-36, 34. LTR 9728021 (Apr. 10, 1997), permitted a taxpayer to use the Specific ID method based on standing order with a broker rather than on a series of instructions each time a trade was executed.

[23] See, *e.g.*, references to stock, bonds and narrow definition of a book-entry security in Reg. §1.1012-1. Note options are addressed but only as part of an investment unit under Reg. §1.1012-1(d) and the relevant portion of the regulations does not address applicable lot relief methods.

[24] See, *e.g.*, *Watson-Moore Co.*, 30 BTA 1197, Dec. 8638.

[25] T.D. 7129, 1971-2 CB 299.

[26] Averaging is currently available for mutual fund shares and certain unit investment trust interests that meet the requirements set forth in Reg. §1.1012-1(e)(5).

[27] Reg. §1.1012-1(e)(2).

[28] Reg. §1.1012-1(e)(6). The election may also be made on a timely filed amended return.

[29] *See, e.g.,* instructions to Form 1040, Schedule D.

[30] Reg. §1.1012-1(e)(6)(i).

[31] Reg. §1.1012-1(e)(6)(ii). Note that the election applies to shares of the same fund held in different accounts.

[32] Reg. §1.1012-1(e)(6)(ii).

[33] Reg. §1.1012-1(e)(3).

[34] Reg. §1.1012-1(e)(3)(ii).

[35] Reg. §1.1012-1(e)(3)(iii)(a).

[36] Reg. §1.1012-1(e)(3)(iii)(b)(2).

[37] Reg. §1.1012-1(e)(3)(iii)(b)(1).

[38] Reg. §1.1012-1(e)(3)(iii)(c) and (d).

[39] *See* Technical Memo CC:LR-1295, dated June 21, 1971, 1971 TM LEXIS 51.

[40] Reg. §1.1012-1(e)(4)(i).

[41] Reg. §1.1012-1(e)(4)(ii).

[42] Reg. §1.1012-1(e)(4)(iii).

[43] Reg. §1.1012-1(e)(4)(iv).

[44] Code Sec. 6045(g)(2)(B)(i)(I). The "any security" reference in the new provision appears to support that the choice of lot relief method can continue to be made on a security by security basis.

[45] Code Sec. 1012(c)(1).

[46] Code Sec. 6045(g)(2)(B)(i)(II). Note that new Code Sec. 1012(d)(1) provides that averaging applies to DRIP stock acquired after December 31, 2010 (rather than after December 31, 2011, which would be consistent with the effective date rules). It is unclear whether the earlier effective date for DRIP stock averaging was unintended, given that the effective dates for basis reporting were delayed one year as a last-minute change before the law was enacted.

[47] *See The Description of the Housing Tax Act of 2008* prepared by the Joint Committee on Taxation, JCX-27-08, Apr. 8, 2008, at 44.

[48] *See* earlier discussion under "Covered Securities and Effective Dates."

[49] Code Sec. 1012(c)(2)(B) and (d)(3).

[50] However, several vendors offer basis calculating software that adjusts for corporate actions, such as BasisPro, offered by Wolters Kluwer Financial Services.

[51] One example is the Capital Changes Reporter offered by Wolters Kluwer Financial Services.

[52] For example, corporate actions relating to foreign securities traded on non-U.S. exchanges may not be covered. Note, however, that the Capital Changes Reporter provides a global corporate action reporting service that covers many foreign securities.

[53] Code Sec. 6045B(a)(2) and (c).

[54] *See* Code Sec. 6045(g).

[55] Code Sec. 301(c)(1) and cross-reference to definition of dividend set forth in Code Sec. 316.

[56] Code Sec. 301(c)(2) and (c)(3). *See also* Reg. §1.301-1(f), Example 1.

[57] *See* Reg. §1.263(a)-2(e) and *Helvering v. Winmill*, SCt, 38-2 USTC ¶9550, 305 US 79.

[58] For a discussion of a variety of issues relating to loads, 12b-1 plans, CDSC and the related shares, *see generally* Johnston and Brown, TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS (WGL, 2008), and Hervey, TAXATION OF REGULATED INVESTMENT COMPANIES, 740-2nd TM, U.S. Income Tax (BNA, 2008).

[59] *See* Code Sec. 1091(a). One interesting mechanical detail relates to whether the 61 day band should be properly centered around settlement date rather than trade date for broker cost basis reporting purposes because broker systems may often be focused on settlement date. Trade date ordinarily controls for recognition and holding period purposes. *See, e.g.,* Rev. Rul. 93-84, 1993-2 CB 225, Rev. Rul. 66-97, 1966-1 CB 190, and Rev. Rul. 2002-44, 2002-2 CB 44.

[60] The mechanics of Code Sec. 1091(d) are a bit convoluted but work. *See* Reg. §1.1091-2 and *see also, e.g.,* Reg. §1.1091-1(h), Examples 2 and 3.

[61] Code Sec. 1223(3). *See also, e.g.,* Reg. §1.1091-1(h), Example 3. There are several interpretations of the mechanics of the wash sale rule holding period adjustment.

[62] *See, e.g.,* American Bar Association, Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of the Joint Committee on Taxation (Mar. 15, 2007), 2007 TNT 52-31.

[63] Code Sec. 6045(g)(2)(B)(ii). One important transition issue relates to the impact of pre-effective date wash sale losses that are triggered due to the acquisition of post-effective date covered securities. The triggering securities subject to basis reporting should carry the related wash sale basis and holding period adjustments.

[64] *See The Description of the Housing Tax Act of 2008* prepared by the Joint Committee on Taxation, JCX-27-08, Apr. 8, 2008, at 45.

[65] "CUSIP" is the abbreviation for the nine-character number used to identify North American securities under the Committee on Uniform Security Identification Procedures. "SEDOL" is the abbreviation for the seven-character number set forth in the Stock Exchange Daily Official List that is used to identify securities in the United Kingdom and Ireland securities markets.

[66] Code Sec. 6045(g)(2)(B)(ii) begins "Except as otherwise provided by the Secretary …"

[67] See, *e.g.*, Rev. Rul. 2008-5, IRB 2008-3, 271, disallowing as a wash sale, a loss on a sale of securities in a taxpayer's taxable account due to a purchase of substantially identical

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ENDNOTES

shares in the taxpayer's IRA account.

[68] *See* Code Sec. 1091(b) and (c) and Reg. §1.1091-1(c) and (d).

[69] *See* reference to short sales as a type of sale under Reg. §1.6045-1(a)(9).

[70] Code Sec. 6045(h)(3).

[71] This article does not address the general tax rules relating to the taxation of options transactions.

[72] *See* references to "option" set forth in Code Sec. 1091(a) and (f).

[73] *See generally* Code Sec. 1272(a)(1).

[74] *See generally* Code Sec. 1272(a)(3)(A)(ii).

[75] Reg. §1.1272-1(b)(1)(ii).

[76] *See* Reg. §1.1272-1(b)(3) for definition of acquisition premium.

[77] *See, e.g.*, Reg. §1.1275-5, Code Sec. 1288, Reg. §1.1275-7 and Code Sec. 1281.

[78] *See* Code Sec. 171 and Code Secs. 1276 and 1278.

[79] *See generally* Code Sec. 1016(a)(5) and Code Sec. 1278(b)(4).

[80] Unlike OID, the market discount rules do not have a comprehensive set of regulations detailing their application. Thus, there are various unresolved questions regarding their application. There are also differences in detail regarding the application of the bond premium rules to municipal bonds.

[81] Debt securities are a type of "other specified security" covered under the applicable date rules set forth in Code Sec. 6045(g)(3)(C)(iii).

[82] There are likely a number of other issues relating to computations of basis for debt due to the various details or lack thereof of rules relating to OID, market discount and bond premium based on the particular type of debt instrument. Additional computational complexities relating to debt securities denominated in a nonfunctional currency are governed by Code Sec. 988.

[83] Note that the definition of a covered security set forth in Code Sec. 6045(g)(3)(A) focuses on securities that are "acquired" (or transferred from an account where the security had been a covered security). In the case of death or gift, it can be contended that the transfer of a security to a recipient does not constitute an acquisition and therefore such security is not a covered security (and therefore not subject to basis reporting). However, even under such contention the security may have been a covered security in the hands of the transferor and it is unclear whether the security escapes the transfer prong of the definition.

[84] Reg. §1.6045-1(c)(3)(i)(B)(1).

[85] Code Sec. 6045(g)(4). S corporations will be treated in the same manner as partnerships for purposes of Code Sec. 6045.

[86] *See* flush language of Code Sec. 6045(b).

[87] Act Sec. 403(a)(3)(A).

[88] Act Sec. 403(a)(3)(B).

[89] Act Sec. 403(a)(3)(C). On November 5, 2008, the IRS posted a notice regarding the scope of the delayed February 15th effective date. *See* CCH FEDERAL TAX WEEKLY, No. 46 (Nov. 20, 2008). SIFMA and ICI have requested clarification.

[90] Code Secs. 6721 through 6724. Failure to provide the IRS and taxpayers with correct cost basis reporting information could subject brokers to significant tax penalty risk. The penalty for an error is essentially $100 per incorrect Form 1099 (a $50 penalty for providing the IRS an incorrect Form 1099 and another $50 penalty for providing the taxpayer with an incorrect Form 1099), subject to a current maximum on the broker for all failures during the calendar year of $350,000 ($250,000 on the returns provided to the IRS and $100,000 on the returns provided to taxpayers). In the case of an error that is due to intentional disregard, the aggregate penalty is the greater of $200 or 10 percent of the amount required to be reported correctly, without any maximum limitation.

[91] *See* references in Act Sec. 403(c)(2) and (d)(2).

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