



GainsKeeper Tax Alert

Senate Committee Staff Releases Cost Basis Reporting Legislation Proposal

By Stevie D. Conlon

On Friday, May 25, 2007, the staff of the Senate Finance Committee released its own cost basis reporting proposal (the "Senate Finance Staff Cost Basis Proposal")—both proposed bill language and a related technical explanation prepared by the Joint Committee on Taxation. The staff has solicited public comment on its proposal no later than June 30, 2007.

There are now four different cost basis proposals: (1) the Simplification Through Additional Reporting Tax (START) Act, introduced by Senator Bayh of Indiana and other Senators and representatives in both the Senate and the House last year and again in February of 2007; (2) the proposal of the staff of the Joint Committee on Taxation delivered to the Senate Finance Committee in August 2006 (the "JCT Staff Cost Basis Proposal"); (3) the cost basis reporting proposal included in President Bush's fiscal 2008 budget released on February 5, 2007 (the "Administration Cost Basis Proposal"); and (4) the Senate Finance Staff Cost Basis Proposal.

Of course, only one version would ultimately be adopted if a cost basis reporting proposal is made law and it is uncertain whether and to what extent such legislation would include various components of the four existing proposals.

What does the release of the proposal mean?

It is uncertain what form cost basis reporting legislation will ultimately take, or if such legislation will be enacted. However, the release of Senate Finance Staff Cost Basis Proposal suggests that cost basis reporting legislation is gaining steam and its ultimate enactment into law could be inevitable, possibly happening later this year.

How does the proposal differ from the others?

The Senate Finance Staff Cost Basis Proposal is more detailed than the other proposals. It includes proposed bill language. Neither the Administration Cost Basis Proposal nor the JCT Staff Cost Basis Proposal includes a draft of proposed language of the cost basis law that would be added to the Internal Revenue Code. The inclusion of proposed bill language permits a more accurate analysis of the scope of the proposal and its provisions. The proposal also includes a technical explanation of the provision prepared by the Joint Committee on Taxation. It is substantially more detailed than any of the explanations of the other proposals (only the JCT Staff Cost Basis Proposal could be considered comparable) and therefore provides additional insight regarding some of the details of the proposal. By contrast, the Administration Cost Basis Proposal is described in only a single paragraph.

There are also two key distinctions of the Senate Finance Staff Cost Basis Proposal that would expand existing Form 1099-B gross proceeds reporting rules that presently cover stocks and securities transactions (along with the basis and holding period reporting rules of the proposal) to: (1) also cover options for which market quotations are readily available on an established securities market on the date of acquisition of the option, and (2) apply such Form 1099 reporting rules (along with the new reporting rules of the proposal) to recipients that are corporations. Under current law, persons are not generally obligated to provide Forms 1099 to the IRS (or the related corporate recipient) for transactions involving holders that are corporations.

In addition, the Senate Finance Staff Cost Basis Proposal explanation clarifies that tax return reporting penalties would apply under various provisions of the proposal. Although anticipated, this clarification effectively raises the bar for the standard of care that brokers (as well as taxpayers providing cost basis records on transferred securities) will need to follow in computing and reporting cost basis information in order to avoid potentially substantial tax penalties.

What are the key elements of the proposal?

In many respects, the Senate Finance Staff Cost Basis Proposal appears to follow the Administration Cost Basis Proposal released in February. Here are some of the key points:

- **Cost basis reporting would require brokers to report the holder's adjusted cost basis and holding period information for securities disposed or exchanged.** The information would be provided under the Internal Revenue Code rules for Form 1099-B. The proposal applies to securities acquired by purchase, gift, inheritance or other means.
- **Cost basis reporting would apply to more than publicly traded stocks and bonds, mutual fund shares and SEC registered real estate investment trust (REIT) shares.** It would also apply to any of the following if market quotations for the security are readily available on an established securities market on the date of acquisition of the security: (1) widely held or publicly traded partnership or trust interests; (2) interest rate, currency and equity swaps, collars, caps and floors; (3) any derivative (including any option, forward contract or short position) in any of the foregoing securities or any currency; (4) a position that is not a security described above but that is a hedge with respect to such a security and such position is clearly identified in the dealer's records before the day on which it was acquired or entered into; and (5) any other financial instrument designated in IRS regulations. An instrument issued by a foreign entity (for example, a foreign stock or option) would also be subject to cost basis reporting if the instrument otherwise satisfies the requirements described.
- **Existing gross proceeds reporting rules and the proposed cost basis reporting rules would apply to options and to corporate recipients.**
- **A broker transferring securities to another broker must furnish to the transferee broker a written statement with information necessary to compute adjusted cost basis and holding period in compliance with cost basis reporting rules.** IRS permitted to issue regulations extending these rules to individuals and other transferors of securities to a broker. Statement required to be provided to the transferee broker not later than the earlier of 45 days after transfer date or January 15 of the following calendar year. Penalty standards for information returns apply to the provider of the written statement.
- **New corporate action information reporting must be provided by issuers of securities subject to cost basis reporting.** Because brokers will be required to report adjusted cost basis and corporate actions (such as reorganizations, stock splits, etc.) relating to securities affect the determination of adjusted cost basis, issuers will be required to report corporate action information. Issuers will need to provide an information return to the IRS describing any action that affects the basis of their issued securities, the "quantitative effect" on the basis of such issued securities resulting from the action, and any other information required by IRS regulations. The return must be filed not later than the earlier of 45 days after the date of the

action or January 15 of the following calendar year. Penalty standards for information returns apply to the provider of the written statement. Written statements setting forth this information must be furnished to holders or nominees no later than January 31 of the calendar year following the action. Nominees will be required to provide statements to their holders as determined under IRS regulations. The IRS will be permitted to waive the return reporting and written statement requirements if the issuer makes certain information publicly available in the manner specified by the IRS, including possibly to an electronic repository.

Commentary: Determining the quantitative affect of actions that are unclear and the application of this requirement to foreign issuers could be problematic. Also, the application of corporate action reporting to options and other instruments subject to cost basis reporting, besides stock and debt instruments, is certainly novel and it is unclear whether such issuers can timely provide such reporting—particularly given that a corporate action on the underlying security or referenced interest rate or currency may be affecting the option or other instrument.

- **Basis computation rules such as FIFO, specific ID and averaging will be determined on an account by account basis.** The Internal Revenue Code rules for computing the basis of particular lots of stock under Section 1012 would be modified. Presently, a taxpayer must aggregate all their holdings in various accounts in applying these rules. Under the proposal, a sale of shares from a particular broker account would be determined by applying the basis rules only to the lots that are within such account (and holdings in other accounts would be ignored).
- **The Senate Finance Staff Cost Basis Proposal would apply to securities acquired after the date that is 18 months after the date of enactment.**

What's next?

It will be interesting to see the extent and nature of comments submitted regarding the Senate Finance Staff Cost Basis Proposal. Because the deadline for comments is June 30, further congressional developments may not occur until after Congress returns from its summer recess. Thus, early fall may be a critical time to see how the cost basis reporting proposals are refined, and for brokers, issuers and taxpayers to consider how they might need to prepare.

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