



CCH Capital Changes White Paper

Basis Reporting Is Coming!
Are You Ready?

By Stevie D. Conlon

In early February 2007, the President's Budget for the upcoming fiscal year was released. Included in its revenue proposals is a legislative recommendation for required basis reporting by brokers for stocks and securities. Basis reporting is intended to raise \$6.7 billion by making sure that taxpayers are correctly reporting gains and losses from their stocks and securities portfolio sales and other taxable corporate actions. In testimony before the Senate Budget Committee on February 14, 2007, IRS Commissioner Mark Everson identified basis reporting as one of the four most important tax related legislative changes proposed by the President.

Everyone is familiar with required reporting of wages to the IRS and taxpayers on Form W-2 and reporting of dividends, interest and gross proceeds by brokers with respect to stocks and securities on various types of Form 1099. The IRS and brokers have wrestled with the scope of information reporting for securities transactions for many, many years and there have always been concerns regarding the burdens of preparing and providing such returns. In 1982, Congress enacted the last major set of expansive Form 1099 information reporting rules for stocks and securities. In the fall of 2005, the IRS instructions for Form 1040 tax returns would have required taxpayers to report all capital gain and loss transactions from stocks and securities on Schedule D and D-1, rather than referencing attached detailed statements from their brokers. Tax return preparers and brokers complained and this proposal was shelved and did not reappear on the recently released instructions for 2006 Form 1040.

The existing IRS information reporting rules, however, have a major gap when it comes to tracking capital gains and losses from stocks and securities sales and other taxable corporate actions. Brokers are already generally required to report gross proceeds from sales of stocks and securities on Form 1099-B. But capital gains and losses are generally determined by subtracting the taxpayer's basis in the stocks or securities sold from the proceeds received. And there is currently no requirement for basis reporting by brokers. Thus, the lack of basis reporting meant that the IRS had no easy way to verify whether taxpayers were correctly reporting the amount of gains and losses from stocks and securities sales and other taxable corporate actions.

The determination of the adjusted basis of a stock or security can be complex. Although the initial cost basis of a stock or security purchased by an investor is typically its cost (including any commission), corporate actions such as stock splits, dividends and mergers and spin-offs often result in adjustments to basis. And different rules apply for determining the basis of stocks or securities received as a gift. In addition, the Internal Revenue Code contains a number of special rules that can trigger adjustments to basis such as the wash sales rule. These complexities can make it difficult for taxpayers and the IRS to accurately compute adjusted basis.

In March 2006 Senator Bayh (Indiana) introduced a bill (S. 2144) that would generally require brokers to report to the IRS and taxpayers the adjusted basis of stocks and securities (such as bonds, notes, debentures or other evidences of indebtedness). This would be accomplished by modifying the existing Form 1099-B gross proceeds reporting rules to require this additional information. Although the bill died with the adjournment of that Congress, the concept of requiring basis reporting by brokers received significant attention and focus before Congress. The National Taxpayer Advocate suggested required basis reporting to simplify tax return preparation by taxpayers and the General Accountability Office (GAO) prepared a report and testified at Congressional hearings on basis reporting. The Joint Committee on Taxation released a 2006 report on the tax gap that included a section on basis reporting and the American Institute of Public Accountants (AICPA) has written in support of the basis reporting proposal.

Basis reporting was also discussed at Congressional hearings in January 2007. Unlike the Bayh bill, the President's proposal would also require brokers to track acquisition and disposition dates of stocks and securities so that holding periods can be measured and capital gains and losses can be properly sorted as short-term and long-term. The inclusion of basis reporting in the President's budget and the remarks of the IRS commissioner are a significant development.

Challenges to Address

There are some important issues raised by the basis reporting proposal. As mentioned before, the rule would generally only apply to stocks and debt instruments. Partnership interests, options and other related types of financial contracts, and foreign currency contract transactions would generally be excluded (although introductory remarks to S. 2144 indicated that the IRS could expand the rule by regulation to cover other types of financial instruments such as derivatives, swaps and options—it is unclear whether this is included in the President's proposal).

For debt instruments, computations of basis can differ from one taxpayer to another based on certain tax elections each taxpayer can make. The basis adjustments for debt instruments can be complex under the Code's bond premium, original issue discount and market discount rules. And, those complexities can be significantly greater for mortgage-backed securities, contingent debt instruments and other types of financial derivatives including component debt securities of certain types of investment products.

In addition, some basis adjustments for stocks or securities can be difficult because the tax treatment of a particular corporate action might be unclear—and the uncertainty might directly affect the determination of basis. This can be true for some complex types of mergers, spin-offs or bankruptcies. It can also be a problem for investments in non-U.S. stocks and securities because it is much more likely that the issuer will not provide a U.S. tax opinion regarding the tax consequences of a corporate action and it may be much harder for the investor or his or her advisor to obtain enough facts to independently determine the appropriate tax treatment. Other tax rules affecting basis would also need to be considered, such as the wash sale rule.

While it is unclear how these complexities will be addressed, the legislative proposals would grant the IRS regulatory authority to ease the reporting requirements if brokers don't have the necessary information.

Broker Concerns

Of course, brokers are worried regarding how generous the IRS would be with such relaxation powers and are hoping for as much detailed guidance as soon as possible so that the rules are manageable and they can do things correctly.

Because some of the information needed to assess the impact of corporate actions on basis would seem to flow from the company involved in the corporate action, the proposal indicates that IRS regulations might also impose a regime requiring reporting of corporate actions by the companies involved and could result in the creation of a central repository. Also, the basis reporting proposal would require brokers to transfer their basis records for investors that transfer their accounts from one broker to another. This "transfer" requirement could be burdensome and details will need to be fleshed out.

Brokers are also concerned about how the new rules will apply due to "grandfathering." Investors will typically have existing accounts with brokers and will hold stocks and securities in such accounts that were acquired before the potential effective date of the basis reporting rules. How will brokers manage the recordkeeping for the tax lots that are acquired in the future and which are subject to the new rules—and those that are grandfathered? What sorts of events or corporate actions could wipe out grandfathered status for a particular lot? And what will be the likely effective date for basis reporting if it is enacted? The answers to these questions are critical since it will determine how quickly brokers and their intermediaries must act to develop the computer software systems needed to comply with basis reporting.

An Issue Worth Following

Basis reporting is not easy. Requiring basis reporting by brokers will impose significant burdens on brokers and comments have already been made regarding the variety of potential issues that need to be considered in meeting any such obligation. It is unclear what form any actual legislation would take and it is always

possible in the sort of horse trading that occurs whenever legislation is on the table that basis reporting could simply be set aside and not enacted. However, these series of recent developments suggests that investors, brokers and other financial intermediaries should carefully consider the potential impact if required basis reporting is enacted into law.

Stevie D. Conlon is the Tax Director for GainsKeeper, a division of Wolters Kluwer Financial Services. She is a tax attorney and CPA and has regularly written, spoken and been quoted in the press on tax issues relating to finance for nearly twenty years.

About CCH[®] Capital Changes

Wolters Kluwer Financial Services is a leading provider of compliance, content, technology, and services for banking, securities, and insurance. We bring together the industry's most trusted and reliable brands to help meet our clients' complex cost basis tracking and objective tax analysis needs on a wide variety of U.S. and International corporate actions. CCH[®] Capital Changes, a part of Wolters Kluwer Financial Services, is the leading tax authority for U.S and global corporate actions. With over 100 years of data coverage, leading financial services firms rely on CCH Capital Changes for its cost basis tracking and legacy of unparalleled legal, tax and accounting analysis of corporate actions. The vast archive of corporate actions coverage found in CCH Capital Changes ranges from value-add tax analysis, commentaries and opinions to gains or losses resulting from taxable transactions and adjustments. Please visit www.capitalchanges.com.

About Wolters Kluwer Financial Services

Wolters Kluwer Financial Services provides best-in-class compliance, content, and technology solutions and services that help financial organizations manage risk and improve efficiency and effectiveness across their enterprise. The organization's prominent brands include Bankers Systems, VMP[®] Mortgage Solutions, PCi, GainsKeeper[®], CCH[®] Capital Changes, NILS INSource[®], AuthenticWeb[™], CCH Wall Street and GulfPak. Wolters Kluwer Financial Services' solutions include integrated and stand-alone compliance and work flow tools, documentation, analytics, authoritative information, and professional services. Customers include banks, credit unions, mortgage lenders, securities, and insurance organizations of all sizes throughout the United States. For more information on Wolters Kluwer Financial Services, visit www.WoltersKluwerFS.com. Wolters Kluwer Financial Services is a unit of Wolters Kluwer, a leading global information services and publishing company with annual revenues (2005) of €3.4 billion and approximately 18,400 employees worldwide. For more information, visit www.wolterskluwer.com.

March 12, 2007

Copyright 2007 Wolters Kluwer Financial Services

DISCLAIMER: The information and views set forth in this article are general in nature and are not intended as legal, tax, or professional advice. Although based on the law and information available as of the date of publication, general assumptions have been made which may not take into account potentially important considerations to specific taxpayers. Therefore, the views and information presented by GainsKeeper may not be appropriate for you. Readers must also independently analyze and consider the consequences of subsequent developments and/or other events. Readers must always make their own determinations in light of their specific circumstances.