New IRS cost basis reporting rules

Changes intended to help investors accurately report gains and losses on sales of securities

The Emergency Economic Stabilization Act of 2008 includes new reporting requirements for financial institutions. Beginning with the 2011 tax year, you and your Advisor will want to consider the new rules when you file your tax return.

Under new IRS regulations, beginning with the 2011 tax year, financial institutions must report to the Internal Revenue Service on clients’ Forms 1099-B not only gross proceeds but also the adjusted cost basis for covered securities sold and whether the related gain or loss is long-term or short-term.

Adjusted cost basis is the original value of a security for tax purposes (usually the purchase price) adjusted for stock splits, dividends and other corporate events. This value is used to determine the capital gain or loss, which is equal to the difference between the asset’s cost basis and the sale price of the closing transaction.

Covered vs. non-covered securities under new rules

The legislation will roll out in three phases starting in 2011. The new IRS reporting requirements will apply only to the disposition of covered securities.

• Covered securities are any purchased or acquired on or after the effective dates.
• Non-covered securities are any purchased or acquired prior to the effective dates.

Transactions involving non-covered securities will continue to be reported as they have in the past, meaning that only gross proceeds (no detailed cost basis) will be reported to the IRS on the sales of these securities. It will still be the investor’s responsibility to report the proper cost basis on non-covered securities. H.D. Vest will not report cost basis information to the IRS on non-covered-security sales.
Tax lot relief methods

In response to the new legislation and to help clients manage the tax consequences of their trading activity, H.D. Vest is making a number of new "tax lot relief methods" available. A tax lot relief method is a way of computing the realized gain or loss for an asset sold in a taxable transaction. It determines which lot of a security as well as its associated cost basis and holding period are used in computing the gain or loss.

When using specific tax strategies, you need to be aware of the tax consequences of your trading activity throughout the year. There may be benefits to using a different tax lot relief method in different accounts or in the sale of some specific covered positions. As in the past, you can choose a specific tax lot to close and instruct your Advisor to execute the closing transaction using the "versus purchase" method. It is important to note that once a specific tax lot is sold, new federal tax regulations prohibit changing that selection after the trade's settlement date. You should consult with your tax advisors to determine the best tax lot relief method for your needs.

Default tax lot relief method

The IRS requires that each firm establish a default tax lot relief method to determine cost basis on all accounts in the event a client does not specify a tax lot relief method. Consistent with current federal income tax regulations, H.D. Vest has elected to use the First In First Out (FIFO) tax lot relief method as our default method.

Available tax lot relief methods

H.D. Vest will make a number of tax lot relief methods available to assist clients with their tax strategies. The following overviews the nine tax lot relief methods clients will be allowed to choose from for their accounts beginning Jan. 1, 2011.

First In First Out (FIFO)

The first tax lot purchased is assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached.

Example

Existing tax lots of XYZ stock in account:

A. 100 shares purchased at $5 per share on May 17, 2011
B. 100 shares purchased at $7 per share on June 9, 2011

1. 100 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot A, the first purchased, would be closed out first to offset the trade.
3. The result would be a $300 short-term gain.

Last In First Out (LIFO)

The most recent tax lot purchased is assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached.

Example

Existing tax lots of XYZ stock in account:

A. 100 shares purchased at $5 per share on May 17, 2011
B. 100 shares purchased at $7 per share on June 9, 2011

1. 100 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot B, the last purchased, would be closed out first to offset the trade.
3. The result would be a $100 short-term gain.
Highest In First Out (HIFO)
The tax lot with the highest cost basis is assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached.

Example
Existing tax lots of XYZ stock in account:
   A. 100 shares purchased at $5 per share on May 17, 2011
   B. 100 shares purchased at $7 per share on June 9, 2011
1. 100 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot B, which has the higher cost basis per share, would be closed out first to offset the trade.
3. The result would be a $100 short-term gain.

Lowest Cost First Out (LOFO)
The tax lot with the lowest unit cost is assumed to be the first sold, regardless of the holding period. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached.

Example
Existing tax lots of XYZ stock in account:
   A. 100 shares purchased at $5 per share on May 17, 2011
   B. 100 shares purchased at $7 per share on June 9, 2011
1. 100 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot A, which has the lower cost basis per share, would be closed out first to offset the trade.
3. The result would be a $300 short-term gain.

Highest Cost Short Term (HCST)
The short-term tax lots and the tax lot with the highest unit cost are assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached. If no short-term tax lots are found or the number of short-term lots is insufficient to cover the sale, the process looks at long-term tax lots and continues to close using highest cost long term (see next).

Example
Existing tax lots of XYZ stock in account:
   A. 100 shares purchased at $8 per share on Feb. 26, 2009
   B. 100 shares purchased at $5 per share on May 17, 2011
   C. 100 shares purchased at $7 per share on June 9, 2011
1. 150 shares of XYZ sold at $8 per share on Sept. 18, 2011.
   The additional 50 shares would come from tax lot B as the only other short-term tax lot available. Although tax lot A has a higher cost basis per share, it is a long-term tax lot and, therefore, would not be used to offset the trade.
2. Tax lot C, which has the highest cost basis per share within the short-term tax lots, would be closed out first to offset the trade.
3. The result would be a $250 short-term gain.
Highest Cost Long Term (HCLT)

The long-term tax lots and the tax lot with the highest unit cost are assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached. If no long-term tax lots are found or the number of long-term units is insufficient to cover the sale, the process looks at the short-term tax lots and continues to close using HCST (see previous).

Example

Existing tax lots of XYZ stock in account:

- A. 100 shares purchased at $8 per share on Feb. 26, 2009
- B. 100 shares purchased at $5 per share on Aug. 14, 2010
- C. 100 shares purchased at $5 per share on May 17, 2011
- D. 100 shares purchased at $9 per share on June 9, 2011

1. 150 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot A, which has the highest cost basis per share within the long-term tax lots, would be closed out first to offset the trade. The additional 50 shares would come from tax lot B as the only other long-term lot available. Although tax lot D has a higher cost basis per share, it is a short-term tax lot and, therefore, would not be used to offset the trade.
3. The result would be a $150 long-term gain.

Lowest Cost Long Term (LCLT)

The long-term tax lots and the tax lot with the lowest unit cost are assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached. If no long-term tax lots are found or the number of long-term units is insufficient to cover the sale, the process looks at the short-term lots and continues to close using lowest cost short term (see next).

Example

Existing tax lots of XYZ stock in account:

- A. 100 shares purchased at $8 per share on Feb. 26, 2009
- B. 100 shares purchased at $5 per share on Aug. 14, 2010
- C. 100 shares purchased at $4 per share on May 17, 2011
- D. 100 shares purchased at $7 per share on June 9, 2011

1. 150 shares of XYZ sold at $8 per share on Sept. 18, 2011.
2. Tax lot B, which has the lowest cost basis per share within the long-term tax lots, would be closed out first to offset the trade. The additional 50 shares would come from lot A as the only other long-term lot available. Although tax lot C has a lower cost basis per share, it is a short-term tax lot and, therefore, would not be used to offset the trade.
3. The result would be a $300 long-term gain.
Lowest Cost Short Term (LCST)
The short-term tax lots and the tax lot with the lowest unit cost are assumed to be the first sold. If the trade requires additional units to be closed, the process is repeated sequentially until the required number of shares is reached. If no short-term tax lots are found or the number of short-term units is insufficient to cover the sale, the process looks at the long-term tax lots and continues to close using LCLT (see previous).

Example
Existing tax lots of XYZ stock in account:

A. 100 shares purchased at $8 per share on Feb. 26, 2009
B. 100 shares purchased at $5 per share on Aug. 14, 2010
C. 100 shares purchased at $5 per share on May 17, 2011
D. 100 shares purchased at $7 per share on June 9, 2011
1. 150 shares of XYZ sold at $8 per share on Sept. 18, 2011.
   2. Tax lot C, which has the lowest cost basis per share within the short-term tax lots, would be closed out first to offset the trade. The additional 50 shares would come from tax lot D as the only other short-term lot available. Although tax lot B has the same cost basis per share as tax lot C, it is a long-term tax lot and, therefore, would not be used to offset the trade.
   3. The result would be a $350 short-term gain.

Minimum Loss Minimum Gain (MLMG) (available later in 2011)
The tax lot(s) that will minimize the trade’s tax impact – coming as close to no gain or loss as possible – is assumed to be the first sold, regardless of the holding period.

Example
Existing tax lots of XYZ stock in account:

A. 100 shares purchased at $5 per share
B. 100 shares purchased at $7 per share
C. 200 shares purchased at $6 per share
D. 200 shares purchased at $4 per share
E. 100 shares purchased at $9 per share
F. 100 shares purchased at $10 per share
1. 400 shares of XYZ sold at $8 per share.
   2. Tax lots B, E and F and 100 shares from C would be closed to minimize the trade’s tax impact.
   3. These tax lots’ total cost ($700+$900+$1,000+$600=$3,200) versus the $3,200 proceeds would result in a zero gain/loss.
We recommend that you consult with your Advisor to determine the best tax lot relief reporting method for you.

Additional firm responsibilities

As a result of the new regulations, financial institutions will have added responsibilities that include:

Asset transfers between financial institutions: For transfers of assets, financial institutions must provide cost basis for covered securities. This includes partial transfers, free deliveries and physical transfers. The transferring firm must provide the receiving firm with accurate cost basis information for covered securities within 15 days of the transfer.

Transfers between accounts (gifts and inherited shares): Gifts and inherited shares must be identified and applicable accounting rules must be applied to the gain/loss.

Wash sales: Financial institutions are responsible for reporting the cost basis information for all covered wash sales involving identical securities within a single account. Clients are still required to monitor wash sales across all accounts and comply with the requirements to compute wash sales under IRS regulations.

Short sales: Prior to January 1, 2011, short sales will be reported in the year the sale is made. Opening short sale transactions executed after December 31, 2010 will be reported on the account’s Form 1099-B in the year the position is closed.

S corporations: S corporations currently receive year-end informational summary statements that are not forwarded to the IRS. Beginning in 2013 (for the 2012 tax year), S corporations will receive consolidated year-end Forms 1099-B that will be reported to the IRS.