

Taxes and Investing - Part III

This email continues our series of reports on taxes and investing.

New IRS Cost Basis Reporting Rules

When you sell a stock, bond, mutual fund or other investment asset, your capital gain or loss for tax purposes is the difference between what you sold the asset for and your tax "basis." In most cases your basis is what you paid for the asset. (Different rules apply if you inherited the asset or you acquired it by gift.)

Until this year, when you sold an investment, all the custodian (for example, Fidelity) had to report to the IRS was the "gross proceeds," i.e., what you sold it for. It was (and still is) the investor's responsibility to report on his/her tax return the basis and the resulting gain or loss.

Now, for the first time, the custodian will also report to the IRS the basis of the asset sold and whether the gain is long-term (held more than one year) or short-term. For some time now many custodians have voluntarily reported this additional information to the account owner as a service, but now they will be reporting it to the IRS as well.

The cost basis reporting requirement is being phased in. It only applies to "covered securities" acquired after certain dates. For the 2011 tax year, the only covered securities are shares of corporate stock purchased in 2011, other than those acquired through a dividend reinvestment plan ("DRIP"). Any corporate stock acquired on or after January 1, 2011 will also be covered for future years' sales. The cost basis reporting requirement does not apply to stock acquired before 2011.

In 2012 the definition of "covered securities" expands to include mutual funds and corporate stock acquired through a DRIP plan beginning that year. In 2013 "covered securities" will include bonds, options and other securities.

The new cost basis information will be reported to taxpayers on an expanded version of Form 1099-B. The reporting requirements do not apply to securities held in IRAs and other retirement plan accounts.

Schedule D and new Form 8949

The IRS has devised a new Form 8949. On one Form 8949 you report all transactions for which the custodian reported a cost basis to the IRS. On another Form 8949 you report all transactions for which you received a Form 1099-B without a cost basis reported to the IRS. On another Form 8949 you report all sales of capital assets for which you did

not receive a Form 1099-B at all (if any). Totals from all Forms 8949 are then transferred to Schedule D.

If you disagree with the basis reported to the IRS on a Form 1099-B, you can put a different basis on Form 8949, but you can expect that to raise eyebrows in the IRS's computers. You might be better served asking the custodian to issue a corrected Form 1099-B. Better yet, review the basis reported on periodic statements from the custodian and raise any issues before a position is sold.

Specific lot identification

If you own a security that you acquired in more than one lot (i.e., not all at one time) and you sell less than all the position, you can designate which lot or lots you are selling from. This will determine the basis and the holding period (long or short term) for the shares sold. However, you must designate a specific lot by the settlement date of the trade. Otherwise the default rule will apply. For Fidelity the default rule for stock purchases is first-in, first-out ("FIFO"). For an account that we manage at CIM, we may designate a specific lot when we sell less than all of a position.

A different default rule will apply to *mutual fund shares* purchased in more than one lot. In that case, unless the account owner has elected separate lot identification, the average cost basis method applies, implemented on an account-by-account basis, and the oldest shares are sold first for purposes of determining the holding period (long-term or short-term).

Here is a simple example of how the average cost basis method works. Suppose you bought 100 shares of XYZ *mutual fund* on June 12, 2010 for \$10 per share, and then you bought another 50 shares of XYZ in the same account on June 12, 2011 for \$9 per share. Every share of XYZ in your account now has a basis of \$9.67 per share, the average cost for all 150 shares. If you sell 50 shares today, they will come out of the shares you bought in 2010 unless you direct otherwise, so it will be a long-term capital gain or loss. The basis for the shares sold is \$9.67 per share even though you paid \$10 per share for the first lot. Every time you buy more shares, the average cost basis is adjusted for all the shares you own in that account.

The average cost basis method is not available for shares of corporate stock other than those acquired through a dividend reinvestment plan.

For any type of investment, you can direct the custodian to use another default rule for your account(s). There is a wide variety of default rules to choose from (which is beyond the scope of this memo).

Wash sales

The Internal Revenue Code suspends the recognition of a capital loss when the taxpayer has purchased a substantially identical security to the one he/she sold within 30 days before or after the sales date, until the replacement security is sold. The new cost basis reporting rules require the custodian to report to the IRS wash sales of the same security in the same account.

Conclusion

In the long run, the cost basis reporting rules should make it easier to track basis and to report gains and losses on your tax return. In the short term, however, we can expect some confusion as the requirements are phased in over time.

As always, consult with your tax advisor if you have specific questions pertaining to your situation.

Please contact your Relationship Manager if you have any questions about the subject of this email, or feel free to contact CIM's Wealth Strategist, Art Dicker, at (518) 391-4280.

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