

New IRS cost basis reporting rules

What You Need to Know for the 2011 Tax Season

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

Under the 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 cost basis for covered securities sold, and whether the related gain or loss is long-term or short-term. Cost basis is the original value of a security for tax purposes — usually the purchase price. The cost basis for a security may also be adjusted for stock splits, non-dividend distributions (return of capital) and other corporate actions. 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.

What will be reported to the IRS?

Covered vs. non-covered securities under the new rules

The new reporting requirements to the IRS apply only to the disposition of covered securities that occur on or after their effective date. A covered security is the type of security purchased or acquired

Securities that are considered "non-covered" are any securities purchased or acquired **prior** to the above effective dates. Transactions involving assets purchased and held prior to these effective dates will continue to be reported as they have been in the past, meaning there will be no detailed cost basis reporting to the IRS on the sales of "non-covered" securities — only gross proceeds. It will still be the clients' responsibility to report the transactions on their tax return along with the proper cost basis on non-covered securities to the IRS. Your brokerage firm and First Clearing, LLC will NOT report cost basis information to the IRS on non-covered security sales.



Talk to your tax advisors

We recommend that you consult with your tax advisor or accountant to determine the best tax lot relief reporting method for you.

on or after its effective date as determined by Congress and the IRS. The legislation is rolling out in three phases, which started in 2011. The effective dates of covered securities are:

- Equity securities acquired on or after January 1, 2011
- Mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012
- Debt securities, options and all other financial instruments acquired on or after January 1, 2013.

Tax lot relief methods

Selecting a tax lot relief method is a way of setting a default for determining the selection of which lots of a security will be liquidated first in a given transaction. In addition to selecting which lot of a security will be sold, it also identifies its associated cost basis and holding period which are used in computing the gain or loss and whether or not it is long-term or short-term.

When using specific tax strategies, clients need to be aware of the tax consequences of their trading activity throughout the entire 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, clients can choose a specific tax lot to close even if they have set a specific tax lot relief method as a default and instruct their financial professional to execute the closing transaction using the “versus purchase” method. Clients should consult with their tax advisors to determine the best tax lot relief method for their needs.

Default Tax Lot Relief Method

The IRS requires that all firms establish a default tax lot relief method to determine cost basis on all accounts in the event a client does not determine a specific tax lot relief method. Consistent with current Federal income tax regulations, First Clearing, LLC is using the default tax lot relief method of First In First Out (FIFO).

Available Tax Lot Relief Methods

First Clearing, LLC now offers a number of tax lot relief methods available to assist clients with their tax strategies. The following lists the eight tax lot relief methods clients will be allowed to choose from for their accounts.

- First In First Out
- Last In First Out
- Highest In First Out
- Lowest Cost First Out
- Highest Cost Short Term
- Highest Cost Long Term
- Lowest Cost Long Term
- Lowest Cost Short Term

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Closing lot information must be provided by settlement date

- Effective January 1, 2011, once a specific tax lot has been sold, Federal tax regulations prohibit the firm or the customer from changing that selection after the settlement date.
- Although the taxpayer has always been required to make a specific tax lot election on or before the trade date, Federal tax regulations now mandate enforcement of this very specific settlement date deadline so cost basis information reported by the firm on a Form 1099-B for a covered security can be matched to the cost basis information reported by taxpayers on their Federal income tax returns.

Understanding wash sale violations and why a loss may be disallowed

- When a stock is sold at a loss, the IRS allows the loss to offset capital gains you might have. Excess losses may be used to offset ordinary income up to \$3,000. The exception to this is a “wash sale.” If the same or substantially identical stock is purchased 30 days before or after the sale, the Federal tax code does not allow current recognition of that loss. This prevents you from selling the stock, taking the deduction and then buying it back within the wash sale time frame to capture any future gains. The wash sale rule can also be triggered by multiple purchases on the same day if one of those tax lots is sold within 30 days for a loss.
- For securities with the same CUSIP number, financial institutions are required to monitor and report wash sales that occur in the same account. They will not be required to track replacement shares if there are substantially “identical” but have different CUSIP numbers, purchased at another institution or even purchased in another account at the same institution. You are required to monitor wash sales across all accounts -- including across institutions or among spousal and other accounts -- and comply with the requirements regarding wash sale positions.

Some corporate action events may have no updated cost basis information provided

- Financial institutions are required to adjust cost basis of covered securities based on issuer corporate action reporting. IRS regulations require issuing corporations to provide shareholders with the applicable tax consequences necessary to adjust cost basis information, or post that information on their web site in lieu of notifying each shareholder directly.
- Shares received in a corporate action event where tax information was not provided by the issuer will result in tax lots without a cost basis. Subsequent sales of those tax lots will result in financial institutions reporting a gain equal to the full amount of the proceeds (i.e. the cost basis information will equal zero.)
- Foreign corporations that are not subject to U.S. tax laws are not obligated to provide U.S. tax implications on their corporate actions. Therefore, the inability to determine cost basis in new shares, rights, warrants, etc. will occur most often in those circumstances.

Changes to your tax packages and tax forms

- IRS Schedule D of the Form 1040 has been reformatted for the 2011 tax year and the new IRS Form 8949 has been added. This new form includes a column to report adjustments to cost basis information we have provided as well as codes to explain the reason for the adjustment. You should consult with your tax advisor regarding any adjustments, such as where the issuing corporation has not provided tax consequences of a corporate action.
- Changes in the IRS forms have prompted First Clearing, LLC to make enhancements to the supporting documentation provided to you. For example, the Realized Gain/Loss information in your year-end tax package has been reformatted to more closely align with IRS Form 8949 which provides the information that flows through to the new IRS Form 1040 Schedule D.

Possibility of increased volume of corrected year-end tax packages

- The majority of Form 1099-B corrections will result from mandatory cost basis adjustments. Additional corrections may result from corrected distribution information from corporate issuers, such as changing a “dividend distribution” to a “non-dividend distribution,” because the latter type of payment results in a cost basis adjustment.
- Form 1099-B corrections are required for up to three tax years once a financial institution becomes aware any previously reported information was incorrect, such as a company revising its dividend distribution information or its issuer return related to an organizational action.

Additional firm responsibilities

As a result of the new regulations, financial institutions have added responsibilities which 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.

Short sales: Opening short sale transactions executed after 12/31/10 will be reported on the client’s Form 1099-B in the year the position is closed. The acquisition and sale dates reported on the Form 1099-B are based on the acquisition date and date shares are delivered to close the short position.

What's Coming in 2012?

Mutual Funds and Dividend Reinvestment Plans (DRIPs) become covered securities as of 01/01/2012. The 2011 cost basis reporting changes that became effective for equities on 01/01/2011 will expand to include mutual funds and DRIPs purchased or acquired on or after 01/01/2012.

S Corporation will be subject to tax reporting as of 01/01/2012. Beginning in 2013 (for the 2012 tax year), S corporations will receive consolidated year-end Forms 1099-B reporting sales of covered securities reported to the IRS. Financial institutions must identify whether corporate account holders are C corporations or S corporations. If it is unknown whether a corporation is a C corporation or an S corporation, it must be assumed that the corporation is an S Corporation and subject to mandatory reporting. If that entity has not provided a certified taxpayer identification number (TIN) on a Form W-9 by the date of the sale, it will be subject to mandatory backup withholding.

First Clearing, LLC, and its affiliates are not tax or legal advisors.

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