The Kitces Report

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Understanding The New Cost Basis Reporting Rules

Executive Summary

- Under the Emergency Economic Stabilization Act of 2008, Congress enacted new rules requiring financial intermediaries to track and report the cost basis of investments.

- The new tracking rules will require any financial intermediaries (i.e., generally all brokers and custodians, as well as certain other types of financial institutions) that currently issue Form 1099-B to report using an updated version, which tracks not only the gross proceeds from sales of securities, but the cost basis, acquisition date, amount of gain/loss, and character of the gain/loss (i.e., short-term or long-term). Copies of the Form 1099-B will be sent to taxpayers, and to the IRS.

- Cost basis tracking and reporting will apply broadly to stocks, bonds, mutual funds, ETFs, commodities, options and other derivatives, and any other securities as specified by the IRS.

- Actual reporting on cost basis will be phased in over time, with equities in 2011, mutual funds and dividend reinvestment plans in 2012, and bonds and other securities in 2013. Due to the varying structures for ETFs, some were implemented in 2011 while others won't be until 2012. Securities that are purchased after these effective dates will be treated as "covered" securities subject to cost basis tracking and reporting; if such covered securities are transferred, the old custodian must provide cost basis information to the new custodian. Securities purchased before these dates are not subject to the new tracking and reporting rules.

- In the case of partial sales from lots with varying purchase prices and/or dates, the broker/custodian will by default assume FIFO (first-in first-out) to account for which share lots are sold first. For mutual funds, the default methodology will be average cost. If a wash sale occurs with the same security in the same account, the custodian will track the adjusted cost basis triggered by the wash sale.

- Investors can opt out of the default method of accounting and choose one of their own, including FIFO, LIFO, highest cost, lowest cost, etc. However, once a sale transaction settles, the identification of whatever lots were sold is locked in and the financial intermediary will report accordingly. Investors can no longer wait until the end of the year to look back and retrospectively decide which lots were sold.

- Making a good decision about a method of accounting will depend on the client situation. While many clients will prefer highest cost to minimize gains and maximize losses, clients eligible for 0% capital gains rates, or those who would prefer today's 15% long-term capital gains rate to the scheduled maximum of 23.8% in 2013, may prefer a lowest cost methodology that deliberately recognizes gains at today's favorable rates.

- In the past, planning firms that tracked cost basis could reasonably rely on their own records; in the future, though, firms must defer to the tracking by the broker/custodian, as these are the amounts that will be reported directly to the IRS. Consequently, it will become increasingly important for firms to reconcile their cost basis information against their custodian. Otherwise firms may not only report incorrect amounts to clients, but could recommend or implement trades for clients that create unintentional adverse tax results.

- In the long run, the new cost basis reporting rules should make it much easier to advise clients on the tax consequences of their investments and transactions. In the near term, though, the new rules create additional complexity for advisors who wish to track cost basis on "old" securities while financial intermediaries track "new" investments. And because the lot identification of a transaction becomes permanent once the trade settles, advisors must plan proactively to choose an appropriate method of accounting with clients.

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Introduction

On October 3, 2008, then-President Bush signed into law the Emergency Economic Stabilization Act of 2008. Although it was widely known as the "bailout" bill - it was the legislation that authorized the Treasury Secretary to use $700 billion under the Troubled Asset Relief Program (TARP) - the legislation also contained a number of measures to help bring in additional revenue to the Federal government. Amongst those provisions was the establishment of a new requirement for brokers to track and report cost basis on securities transactions to the IRS, to better ensure that taxpayers properly their gains and losses on investments and pay taxes as appropriate.

Over the long run, the new rules will make it easier for clients to track the cost basis for most of their investments, simplifying reporting and preparing returns during tax season. However, in the intermediate term, the introduction of cost basis reporting brings new complexities and challenges for financial planners to manage. In addition, the new reporting rules will require clients and their planners to make good decisions up front about a method to identify which securities lots are being sold - *which cannot be changed after the time they are sold* - or risk having a sub-optimal tax result, especially in light of today's long-term capital gains tax rates.

Hopefully, this month's newsletter will help you to understand the new rules and obligations for cost basis reporting, and to formulate your own guidance to clients about which lot identification methods to use to ensure an optimal tax result based on the client's own individual circumstances!

Technical Background

The new cost basis reporting rules were actually part of the Energy Improvement and Extension Act of 2008, and were designed to help generate Federal tax revenue to offset the cost of certain energy-related tax credits; however, the legislation was ultimately enacted when it was attached to the Emergency Economic Stabilization Act of 2008 (EESA) that fall.

In turn, even though the Emergency Economic Stabilization Act of 2008 (EESA) was signed into law in October of 2008, the new cost basis reporting rules themselves under the amended IRC Section 6045 were enacted with a delay provision that didn't actually require financial intermediaries to implement them until 2011. These new rules for financial intermediaries affected any brokers, custodians, or other firms that were already required to submit Form 1099-B reporting to the IRS. In addition, the new rules were scheduled to phase in slowly over time; not only did financial intermediaries have until 2011 to get their reporting systems adjusted to handle the new requirements, but the 2011 enactment date only applied to a limited number of securities.

Specified Securities

Technically, the new rules of Section 403 of EESA stipulated that financial intermediaries must report cost basis information to both investors and the IRS for "specified securities" which include:

- Equities, including dividend reinvestment plans

- Mutual funds and ETFs

- Bonds

- Commodities, options, and other derivatives

- Any other securities as specified by the IRS (Further Treasury Regulations are likely to be issued in 2012 to provide additional detail about what other financial instruments may be specified securities.)

Covered Securities

Specified securities purchased after certain effective dates are known as "covered securities", which means the financial intermediary is subject to reporting requirements when the specified security is subsequently sold. The effective dates for purchases of specified securities to be treated as covered securities are:

- January 1, 2011, for equities;

- January 1, 2012, for mutual funds and dividend reinvestment plans (see Sidebar, next page, regarding ETFs and ETNs)

- January 1, 2013, for all other financial instruments, including bonds, commodities, options, derivatives, etc.

In the case of a short sale, the date the short sale position is *opened* is used to determine whether it will be a covered security; if it is, the financial intermediary will be required to report any gains or losses on the transaction once the position is closed and the security is bought back.

Reporting Requirements for Covered Securities

The reporting requirements - new sections added to the existing Form 1099-B for income reporting - include the cost basis of the security that was sold (or the short position that was closed), which can be combined with the reporting of gross proceeds from the sale to determine the amount of gain or loss, and the type of gain (long-term or short-term) depending on the acquisition date (and therefore, the holding period) for each and every sale transaction.

Cost basis for reporting gains/losses should include the cost of any transaction fees or commissions directly allocable to the purchase transaction. If multiple lots are purchased in the same day under a single trade order with a single transaction confirmation, the cost basis of all the intra-day lots can be the average cost across the day (unless the investor opts out); however, if multiple purchases are made within the same day as a result of separate buy orders, each lot is still tracked separately for cost basis purposes.

The financial intermediary is also expected to track subsequent corporate actions that can impact the cost basis of the shares, such as stock splits or reverse splits, return-of-capital distributions, spin-offs, etc. Corporate issuers of securities that implement such corporate actions are required to provide information regarding the adjusted cost basis impact to investors within 45 days of the corporate event (or by January 15th of the following year if the corporate action occurs in December) on Form 8937 or via the issuer's website. If there is a correction to a prior corporate action tax event within 3 years, the corporation must issue corrected information, and the financial intermediary is required to issue a corrected Form 1099-B.

Lot Identification

For sale transactions where only some, but not all, of the position is sold, a decision must be made to identify which share lots were sold. By default, financial intermediaries will use first-in, first-out (FIFO) reporting for stocks, bonds, and other securities, and average cost for mutual funds and

When Are ETFs (and ETNs) Covered Securities?
Because of the myriad of ways that Exchange-Traded Funds (ETFs) are structured, not all ETFs will become covered securities at the same time.

Generally, ETFs that are structured as regulated investment companies (RICs) will become covered securities beginning on January 1, 2012, as - for the purposes of determining whether they are covered securities - these are treated the same as mutual funds (which are also RICs).

However, ETFs that are structured as unit investment trusts (UITs) - such as the S&P 500 '*SPY*' SPDRs and the Nasdaq 100 '*QQQ*' - are generally viewed as being more akin to stocks, and some custodians have been treating them as covered securities for 2011.

On the other hand, ETFs that are structured as grantor trusts are even more ambiguous. Some have suggested that they may escape the reporting requirements entirely. Others believe that they must and will ultimately be caught up in the "catch-all" provisions for covered securities in 2013 - if only because the Treasury may identify them as specified securities subject to the rules, simply because the Treasury is given the leeway to make such declarations if they deem it appropriate.

Notably, the prevailing view for ETFs in recent years has been that those structured as RICs - but not as grantor trusts or UITs - are eligible for average cost treatment, although thus far it appears that most custodians are offering FIFO as the default treatment for ETFs.

Exchange-traded notes (ETNs) - often used for commodity or currency exposure - do not appear to fall cleanly into any of the definitions for specified securities, although it appears likely that they too will be covered under the general provision for 'other financial instruments' beginning in 2013, like grantor-trust ETFs.

The bottom line is that because of the uncertainty surrounding ETFs, advisors should be aware that some custodians may begin reporting on ETFs in 2011, while others are not reporting on them until 2012. Many custodians that report on ETFs in 2011 or 2012 may still not report on ETNs until 2013. Advisors will need to be cognizant of how their clients' custodians will be treating these securities if they are held in client accounts, to ensure that the advisor's information reconciles with the custodian's, and especially because the client should make an affirmative decision about what cost basis method of accounting to use on those ETFs at the point the custodian plans to treat them as covered securities.

dividend reinvestment programs, implemented on an account-by-account basis (i.e., if stock shares in an account are sold, it is assumed that the oldest shares in *that* account are sold, even if there are older shares in another account; if mutual fund shares are sold, it's based on the average cost of the shares in *that* account).

If the clients wishes to use a different methodology than the default to identify which lots are sold, the client can (and must) request a change to a different method of accounting for lot identification. However, once a share is sold and the transaction settles, the lots identified for that particular sale and their associated cost basis will be locked in and reported by the financial intermediary. No change to the identification of which lots were sold can occur past the settlement date of the sale transaction (which is generally 3 business days after the trade date for most stocks and bonds, but 1 business day after the trade date for mutual funds, options, and government bonds).

Special Rules for Average Cost

As noted earlier, the default method of accounting for mutual funds (and dividend reinvestment plans) will be average cost, implemented on an account-by-account basis, and *not* aggregated across all holdings of the mutual fund as occurred in the past. If the average cost mutual fund shares include both short-term and long-term shares, the shares are assumed to be sold on a FIFO basis to maximize eligibility for long-term capital gains.

The per-account reporting allows each financial intermediary to calculate cost basis with respect to that institution's own positions, without needing to be aware of the (average) cost of mutual fund shares held elsewhere. This also means that individuals could elect average cost for the mutual fund shares held in one account, but not the mutual fund shares held in another account; notably, it also means that there will be a separate average cost (or even difference in whether average cost is used) for covered mutual fund shares and non-covered shares in the *same* account, unless the owner specifically requests for all shares all to be aggregated using the same average cost.

Starting in 2012, investors can change from specific lot identification to average cost at any point, without requesting approval to the IRS for a change in method of accounting. Any change in mutual fund accounting method applies to future sales that occur after the change request is made to the broker. If average cost has already been elected, it can only be revoked by the *earlier* of one year, or when a sale occurs for which average cost accounting would apply. After that point, average cost accounting is locked in for that group of shares, although the investor can still request a change in method of accounting for any new shares acquired going forward. There is no limit to the number of times a change in cost basis accounting methods can occur for new shares being purchased from that point forward.

Notably, when the new rules for tracking mutual funds take effect beginning in 2012, the old "double category method" for determining short-term and long-term capital gains and losses for mutual funds with average cost no longer applies.

Wash Sales

Financial intermediaries will also be responsible for monitoring for wash sales under the new cost basis reporting rules, but only in the limited situation where the exact identical security is bought and sold - i.e., those with the same CUSIP number - and in the exact same account - i.e., the broker does not need to monitor across multiple shareholder accounts, including and especially with respect to shares that may be held at another institution.

Notably, this is *not* a change to the rules regarding what constitutes a wash sale, which still applies not only when the identical security is bought, but when a "substantially identical" security is bought, and regardless of which account it is purchased in. The new wash sale *reporting* rules are only intended to clarify which wash sales the broker must *automatically* track and report, versus wash sales that the investor is still responsible for tracking and self-reporting.

Account Transfers

Beginning in 2012, if a client transfers accounts to a new financial institution, the old intermediary must provide the new financial intermediary, within 15 days of the transfer, the cost basis information (purchase amount and original acquisition date for each lot) for any covered securities. In 2011, transition relief provisions removed penalties from brokers that failed to provide transfer information in certain situations for stocks that were covered securities; nonetheless, the rules apply in full for covered securities - including potential penalties for failing to properly report transfers - beginning in 2012.

Additional rules for transfers apply in the case of covered securities that are transferred due to gift, or due to bequest from a decedent. In the case of transfers due to bequest, the financial intermediary must report not only the original acquisition date of the security, but also the date of death of the decedent and the stepped-up cost basis of the inherited security as of that date of death (unless an authorized representative reports a different amount, such as due to electing the alternative valuation date, or providing a valuation in the case of illiquid securities that don't have a readily ascertainable value). When the transfer is due to gift, the transfer statement must include not only the donor's carryover cost basis (*without* adjustment for any gift taxes paid) and the original acquisition date, but also the date of the gift transfer and the fair market value on the date of the gift. The latter information is necessary because, in the event of a gift where the fair market value is below the donor's cost basis at the time of transfer, the donee recognizes losses based on the value *when gifted*, but recognizes gains based on the donor's original (and higher) carryover cost basis, per the standard rules on the income taxation of sales of property gifted at a loss. On the other hand, the rules do specify that gift transfer reporting (where the fair market value is used to determine losses by the donee) is not necessary nor appropriate where the gift occurs between people for whom these rules don't apply (e.g., transfers between spouses), as long as the financial intermediary is notified (although in practice, it may take time for brokers/custodians to develop policies and procedures to handle this). And again, in any event, all of the aforementioned reporting rules for transfers due to bequests or gifts apply only to investments that are covered securities.

Reporting Timing Requirements And Penalties

To provide slight relief for the time it takes to collect this information and ensure it is correct at the close of the tax year, the deadline for issuing Form 1099-B from financial intermediaries to taxpayers for a given tax year is permanently shifted from January 31 of the following year to February 15 (the due date for the IRS' copy of the 1099-B is February 28).

Inaccuracies from the reporting institution regarding cost basis and gains recognized can result in penalties for the institution (as amended with recent changes under the Small Business Jobs Act of 2010) of $100 for each incorrect Form 1099-B sent to investors, and another $100 for each incorrect Form 1099-B sent to the IRS, up to a maximum of $1,500,000 per year for each of those categories (with unlimited penalties for intentional disregard of the new requirements). Thus, to say the least, there is a significant onus on financial intermediaries to accurately track and appropriately report cost basis and realized gains/losses on sales.

The Past, Future, and Present of Cost Basis Reporting

Historical Challenges to Cost Basis Reporting

Historically, an accurate determination of cost basis has often been difficult. Over the past two decades, a dramatic increase in the use of personal finance software has somewhat eased the burden, but in practice determining accurate cost basis has still been a challenge. This has been especially true in situations where corporate actions like splits and spin-offs could impact cost basis per share even if there were no sales, or where an investor had a long sequence of purchases and partial sales that sometimes had to be reconstructed to determine the cost basis of what was left in an exercise of forensic accounting. In fact, the concept of step-up in basis of assets to the fair market value on the date of death was created more as a way to ease the cost basis and gains reporting requirements for beneficiaries of decedents, as it was any kind of intentional tax relief for inheritors; otherwise, good luck reconstructing Mom and Dad's cost basis in securities that might have been owned for years or even decades, with limited records, and no way to ask the original owners for background or context regarding the transactions!

While the burden and challenge of tracking gains and losses could have also been theoretically eased by cost basis reporting from the financial intermediary that held the securities, only some institutions have voluntarily done so, and at best typically only provided limited information, as the intermediary did not want to be held legally liable for any mistakes or miscalculations. However, with the implementation of the new cost basis reporting requirements, financial intermediaries no longer have the option; they must help investors track cost basis, and report it to the IRS, or face penalties for failure to do so (or for completing the reporting incorrectly).

The Long-Term Future of Cost Basis Reporting

In the long run, the new cost basis reporting rules greatly simplify tracking issues for cost basis and the amount of unrealized and realized capital gains (or losses) a client may face. Investors will receive annual reporting from their broker or custodian regarding the amount of capital gains (and losses) that were realized during the year (not merely the gross value of positions that were sold); during tax season, a client will merely need to provide an accountant with the Form 1099-B to complete all gain/loss reporting on Schedule D.

Clients who do a poor job of keeping their own records of transaction history won't need to worry, as the reporting information will be provided to them; even if the client moves their investments around to various financial institutions, each broker/custodian will report the cost basis of all the positions to the new institution, eliminating any risk that the client loses track of cost basis or faces the difficulty of trying to get transaction history for an account that is no longer active. Advisors will be able to get a quick report of an existing client's capital gains exposure, and similarly will be able to get a summary of any capital gain/loss exposure a prospective client faces before beginning a new investment program.

Simply put, the long-term future of the new cost basis reporting rules should largely eliminate most uncertainties regarding actual cost basis of investment positions, along with any realized and unrealized gains or losses. Tax reporting will be expedited, as will the transition process for a planner evaluating the tax exposure of a new client's investment positions.

Cost Basis Reporting Issues At The Present Time

Notwithstanding the ease of reporting that will ultimately be reached in the "new world" of cost basis reporting in the longer-term future, important decisions remain for planners and their clients in the near term. Most significantly, planners and clients must choose a method of accounting for each position in each account, which must be determined in advance of any sales (or at the time of sale itself).

In addition, as will be discussed further in later sections, other challenges remain during the transition period - which may last for many years - as the new rules slowly phase in, and clients hold an assortment of covered and noncovered securities across various accounts.

Choosing a Method of Accounting

When an investor sells an entire investment position, any issues regarding the method of accounting for which lots were sold is a moot point; they were all sold, and the gain is simply the total proceeds minus the total cost basis, regardless of the number of different lots that were purchased over time and their various cost bases. At the worst, the client simply needs to separately calculate the gains and losses for lots held less than a year, from those held for more than a year, to determine which gains/losses are short-term and which are long-term; nonetheless, the total amount of gain remains the same, and the issue is only the character of the gain.

Similarly, in a situation where an investor buys an entire investment position in a single transaction, the method of accounting for sales is also a moot point; every share has the same cost basis and the same purchase date, and consequently a sale will report the same amount and character of gain, regardless of how the investor tries to select which (of the identical) lots are sold.

However, in the scenario where there are multiple lots purchased over time with different cost bases and/or acquisition dates, *and* where only part of the investment position is sold, the situation is different; now, identification of which lots were sold will matter, as not all of them have the same cost basis and holding period. With partial sales from amongst shares with varying cost bases, which lots are identified, and the cost basis associated with those particular lots, directly impacts the size of the gain or loss realized.

The breakout box on the next page highlights the 6 most common methods of accounting used for investment positions. Technically, these methods can and would be used for any/all positions, whether the investor bought or sold the securities all at once or in segments; however, the methods would only produce different results in a scenario where there had been multiple purchases over time, followed by a sale of only a portion of the position.

Determining The "Best" Method Of Accounting

In looking amongst the various choices for lot identification accounting methodologies, which is "best" will depend on the circumstances of the client. To the

Common Methods of Accounting for Investments

There are 6 typical cost basis accounting methods used by investors, each of which can produce a different tax result, depending on the array of shares that were bought and sold.

First-in, First-out (FIFO) - Whatever shares were purchased first, are assumed to be sold first. This ensures that if there are any shares eligible for long-term capital gains treatment, they will be sold first (as they would be amongst the oldest). To the extent that markets go up more than they go down, this methodology will also tend to choose the shares with the largest gain, as in the long run the oldest shares often had the cheapest original cost. However, even over periods of years, there can be large variations in the cost of various lots due to market volatility; as a result, FIFO can sometimes be arbitrary in selecting whether the shares sold represent a large gain or a small gain (or even a loss), simply due to the timing of when they were purchased and the cost at that time. FIFO is often more effective to use when all the shares were purchased around a similar time frame, and/or at a similar cost, where the amounting gains are likely to be comparable regardless of which lots are sold anyway, but the taxpayer wants to ensure the long-term shares are sold first. Notably, FIFO is the *default* method of accounting to be used by financial intermediaries, except for mutual funds, or where requested otherwise by the investor.

Last-in, First-out (LIFO) - In the case of LIFO, whatever shares were purchased *last* - i.e., most recently - are assumed to be sold first. On average, this may produce smaller gains than FIFO, as the shares purchased most recently are less likely to have appreciated significantly (although obviously, exceptions can occur). On the other hand, because the shares were purchased most recently, they will potentially be subject to short-term capital gains (or loss) treatment, if the sale occurs within a year of the last purchase. LIFO can be a more effective method than FIFO to reduce capital gains exposure, by allowing longer-term more-appreciated positions to continue to be held and minimizing the amount of current gains, but increases the risk that any gains that are taken may be short-term, and therefore taxed at higher (ordinary income) rates than long-term gains.

Highest Cost - With highest cost, the shares assumed to be sold are whichever have the highest cost basis, regardless of the timing of when they were purchased. Since by definition the highest cost basis shares are sold first, this methodology will harvest the (biggest) losses first, then gains from smallest to largest, although some of those gains may be short-term gains taxed at ordinary income rates, since highest cost ignores the purchase date. On the other hand, if *all* of the portfolio's positions are long-term (or all short-term), such that the acquisition date no longer matters, the highest cost methodology simply harvests the losses first (biggest to smallest) and then the gains (smallest to largest).

Lowest Cost - The opposite of highest cost, this methodology assumes whatever shares have the lowest cost are sold first, again regardless of their holding period or original purchase date. Accordingly, using lowest cost maximizes the amount of gains realized (and/or minimizes losses). This method of accounting is generally most effective where there is a proactive reason to harvest the maximum amount of capital gains, such as taking advantage of a unique favorable tax rate situation, absorbing capital losses or some other form of deduction or credit, etc.

Average Cost - For mutual funds, an alternative to choosing one of the aforementioned default methods of accounting. Average cost simply adds up the total cost basis and divides by the total number of shares to determine the average cost for each share, and that is the cost basis applied to any share(s) that is(are) sold. This methodology can greatly simplify cost accounting, and potentially smooth out gains and losses realized from year to year. On the other hand, if an investment is particularly volatile, with a wide range of purchase prices, using average cost may afford less tax planning flexibility than the preceding methods, as the investor cannot choose to cherry-pick lots to recognize a particular large or small gain (or loss) in a particular year, but instead must use the same average cost for every year and every transaction. It is notable that once average cost is selected for a mutual fund and a sale occurs, the investor is locked into average cost for all of those shares, although beginning in 2012 a different method of accounting can be chosen for subsequent shares purchased in the future.

Specific Lot - Another alternative to choosing one of the aforementioned default methods of accounting (including an alternative to average cost for mutual funds), the investor's intended "method" can be to choose a specific lot *at* the time of sale. On the one hand, this can create significant additional work for the investor (or the advisor), as each transaction for which lot identification is important will require personal attention to choose which lot will be sold. On the other hand, by choosing the specific lot at the time of sale with each and every transaction, the investor can ensure that the "best" lot is chosen, with the optimal gain or loss, based on the tax situation at that exact time.

extent that clients wish to minimize capital gains and maximize capital losses, the most common rule planners and clients would likely pick is Highest Cost, as most clients prefer to minimize current capital gains exposure and defer the largest gains as long as possible. Although in some situations LIFO might produce similar results (at least for securities that steadily rise in value over time, such that the latest shares are the highest cost), in other situations where the investment has a lot of price volatility the LIFO option may result in large short-term capital gains; thus, in practice, it will likely be easier and preferable to simply select Highest Cost, which will ensure minimized gains and maximized losses.

The greatest caveat of the Highest Cost methodology is that, because it entirely ignores holding period, it may harvest a short-term capital gain over a slightly larger (lower cost) long-term capital gain, resulting in less wealth for the client.

> *Example 1*. Harold purchased 1,000 shares of ABC stock early last year at $80/share, and another 1,000 shares of the same stock a few months ago for $82/share. Due to a favorable news event, the price of ABC stock recently jumped to $100/share, and Harold would like to sell half the position to take some of his gains off the table. Using the Highest Cost methodology, Harold will sell his ABC shares purchased a few months ago for $82/share, resulting in an $18/share gain. The total proceeds from 1,000 shares at $100/share is $100,000, and the total gain is $18,000; assuming a top 35% Federal tax rate (i.e., short-term capital gain at ordinary income tax rates for a high income taxpayer), Harold pays $7,200 in Federal taxes and has $92,800 remaining to reinvest. On the other hand, if Harold had sold his long-term shares first - albeit with a slightly lower cost of $80/share - his total capital gain would have been $20,000, but the entire gain would have been long-term at a Federal tax rate of only 15%, resulting in a tax liability of only $3,000 and leaving $97,000 remaining to reinvest. Thus, by selling the highest cost shares, Harold minimized the *amount* of the gain, but ended out having less *after-tax value* to reinvest.

To address this issue, some financial intermediaries offer a 7th method of accounting option. It goes by various names - tax-sensitive, optimal tax, most-beneficial tax, etc. - but the basic gist is the same for all of them: it is a method that seeks to minimize gains and maximize losses a la Highest Cost, but still pays attention to holding period and whether gains will be short-term or long-term. For instance, the rules might state:

> **Tax-Sensitive Highest Cost**
> Sell shares in the following order:
>
> - Short-term capital losses, from the biggest loss to the smallest
>
> - Long-term capital losses, from the biggest loss to the smallest
>
> - Long-term capital gains, from the smallest gain to the biggest
>
> - Short-term capital gains, from the smallest gain to the biggest

By following the above methodology, the highest cost shares are still substantively sold first, as the highest cost shares that can produce a loss (if available) get sold before the investor liquidates the lower cost shares that result in gains. However, in light of the strong preference for short-term losses over long-term, and for long-term gains over short-term, this method of accounting ensures that while the highest-cost (biggest losses) are sold first, all short-term capital losses are redeemed before any of the long-term capital losses. Similarly, all long-term capital gains - at preferential tax rates - are liquidated before any short-term capital gains are realized, even if the *amount* of long-term capital gains is greater.

Notably, in such a scenario, it is still possible to get an adverse tax result, for instance by harvesting shares with a $1,000 short-term loss instead of shares with a $30,000 long-term loss, or by liquidating stock with a $30,000 long-term capital gain instead of only a $1,000 short-term capital gain, whereas a basic Highest Cost methodology would have produced the opposite, more favorable lot selection in this particular case. Nonetheless, it would require a significant variance of purchase prices between short-term and long-term positions to create such disparities. In most situations, this form of Tax-Sensitive Highest Cost will create superior results to a basic Highest Cost or LIFO treatment - at least for clients seeking to minimize current gains - and it will likely be the most common method of accounting chosen by/for clients.

An Alternative To Highest Cost

Notwithstanding the general tax planning prudence of maximizing current deductions (e.g., capital losses) and minimizing current income (i.e., capital gains) - a framework best supported by a (tax-sensitive) Highest Cost method of accounting - there are situations where the opposite method of accounting, Lowest Cost, may be preferable.

For instance, under current law, the 15% long-term capital gains rate is scheduled to lapse back to 20% in 2013. In addition, under the Patient Protection and Affordable Care Act of 2010 (the so-called "Obamacare" health care legislation), a new Medicare tax of 3.8% on unearned income for high income taxpayers also takes effect in 2013. Consequently, some very high income clients may see their long-term capital gains tax rate increase from 15% to 23.8% in barely a year. A client who faces a long-term capital gain of $100,000 on a significant investment position will pay $15,000 in Federal long-term capital gains taxes now, but $23,800 in 2013, an increase of 52%! In such a scenario, the client would actually be better off harvesting shares with the biggest gains now - at 15% rates - than deferring them to the future - at 23.8% rates. Accordingly, such a client may generally prefer to use a Lowest Cost methodology, not a Highest Cost one, as the goal would be to deliberately recognize as much as possible in long-term capital gains and pay them at current rates instead of future rates.

Similarly, under current law clients who are in the lowest two ordinary income tax brackets (the 10% and 15% brackets) are eligible for 0% tax rates on long-term capital gains that fall within those brackets (after deductions), although the tax rate is scheduled to revert to 10% in 2013. For such clients, using a Highest Cost methodology could actually *damage* their long-term wealth accumulation.

> *Example 2*. Thomas sells a stock with a $15,000 cost basis and a $10,000 current value under a Highest Cost accounting method, and reinvests the $10,000 proceeds into a new stock. Since Thomas faces a 0% capital gains tax rate, using the $5,000 loss to offset his gains results in a tax savings of $0. On the other hand, if the new investment ultimately appreciates back to $15,000 in a few years, Thomas will face a future tax liability of 10% on the gain, resulting in a $500 tax liability. Through Highest Cost accounting, Thomas enjoyed a $0 savings on the $5,000 loss and a $500 tax on the $5,000 gain, actually *reducing* his long-term wealth. Thomas would actually have been better off selling another share lot with his Lowest Cost shares, potentially producing a gain that would be subject to a 0% tax rate and resetting his cost basis higher to further minimize future gains at higher rates; in addition, by keeping his higher cost shares with an embedded loss, Thomas can enjoy appreciation from $10,000 back to $15,000 in the current position with no tax liability, even if rates rise, because Thomas' cost basis *already is* $15,000!

As the preceding example shows, clients that are in the lowest tax brackets after deductions ($69,000 of taxable income in 2011 for married couples, or $34,500 for singles, indexed annually for inflation) would be far better served with a Lowest Cost method of accounting, not a Highest Cost version. Ideally, the client would actually use a methodology that claims *long-term* capital gains first, then harvests short-term and long-term losses, and leaves short-term capital gains for last (as they are still taxed at ordinary income rates); in practice, though, if a client uses a Lowest Cost methodology, there is a risk that it will result in harvesting some short-term capital gains as well. At this point, it simply doesn't appear that most financial intermediaries have an optimally tax sensitive form of Lowest Cost accounting as has been developed by some for Highest Cost accounting. Nonetheless, for lower income clients at lower tax rates, even harvesting gains at short-term rates may not be too adverse, if the short-term (ordinary income) tax rate is 10% and the long-term capital gains rate in 2013 was going to be 10% anyway, and harvesting a small amount of short-term gains may still be a small price to pay if it also allows harvesting a larger amount of long-term capital gains at 0% tax rates.

Are Highest Cost and Lowest Cost The Only Viable Options?

Given the effectiveness of Highest Cost as a method of accounting to minimize gains and tax liability, and Lowest Cost as an alternative for those clients who actually *want* to recognize gains (e.g., to harvest at favorable 0% or 15% tax rates), the question arises: will clients ever wish to choose one of the *other* alternative methods of accounting?

Arguably, the answer is "no". The nominal goal of using LIFO - to select the most recent and hopefully highest cost shares - is better achieved by simply choosing Highest Cost, especially if a tax-sensitive version is available. Similarly, the nominal goal of using FIFO - to sell the oldest and hopefully lowest cost shares to harvest capital gains - is better achieved by simply choosing Lowest Cost.

Many clients over the years have chosen average cost where available for mutual funds, but arguably most choose it not because it provides the optimal tax result, but simply because it is the easiest to track and report. In a world where taxpayers were responsible for their own cost basis tracking, simplicity was an appealing option, especially if the difference between average cost and the other methodologies was negligible anyway (e.g., where the primary purchase was a lump sum, and the ongoing purchases have simply been modest dividend reinvestments, such that nearly all of the shares still have the same cost basis from the initial buy). On the other hand, now that more sophisticated measures are available - such as Highest Cost, or tax-sensitive Highest Cost - *and* can be tracked and reported *automatically* with no additional work for the taxpayer, it's difficult to see why clients would select the average cost method. Even clients who state "I don't really care which method is used" would arguably still be better off using Highest Cost and minimizing ongoing taxation, if only for the basic value of managing investments tax-efficiently and maximizing tax deferral (all else being equal).

And while specific lot identification can always be used, in practice most investors would probably still be better served to pick some other default - e.g., Highest Cost or Lowest Cost - and then just altering the lots sold for a particular transaction at the time of sale for that particular sale (which can always be done before the sale settles, except where locked into average cost for mutual funds). Thus, the client might as well choose *some* default method - whatever is most likely to be applicable for the client's particular situation - and then simply deviate as necessary when a sale occurs.

Notably, though, the *default* for mutual funds is still average cost; thus, clients who wish to follow a more tax-efficient route will need to proactively change from the default method once the rules come into effect in early 2012 (which can be done simply by providing notification to the broker/custodian of the alternative, preferred method of accounting instead of the default). Some clients may wish to elect an alternative method from average cost simply to allow themselves flexibility down the road, to avoid the reality that once a sale occurs with average cost, that method is locked in for those shares forever.

Practical Challenges & Concerns

Although the basic rules for cost basis reporting are relatively straightforward - the custodian adopts default method of accounting rules unless instructed otherwise, and provides the Form 1099-B reporting the amount of gains and losses on covered securities and whether they're short-term or long-term at the end of the year - several near-term practical challenges and concerns arise.

Reconciliation of Cost Basis Accounting Between Systems

First and foremost is the fact that while, in the long run, financial intermediaries will report on all positions in a client's portfolio - because eventually virtually all clients will only hold covered securities that were purchased after the effective dates for tracking - in the short to intermediate term, most client portfolios will contain a mixture of covered and non-covered securities. As a result, planners are not off the hook in the foreseeable future for at least assisting clients on cost basis issues for their portfolios. Over time, an increasing portion of clients will own covered securities, but it will likely take years to transition as clients slowly turn over the positions in their portfolio and replace old noncovered securities with new covered ones. Ironically, new clients who change their investments upon engaging the planner will actually be simpler to track, as a new portfolio with a new advisor entails new purchases that will generally be covered securities; it's the long-term existing clients with the lowest-turnover, most tax-efficient portfolios, who will have noncovered positions the longest.

Currently, many financial planning firms - especially those who also provide investment management services - already help clients track cost basis via the firm's portfolio management software. For long-term clients with noncovered securities, this may be the easiest way to continue to assist clients on cost basis issues. However, running in-firm portfolio management software for client investment accounts while the broker/custodian also tracks the cost basis of covered securities introduces a new challenge: reconciliation between the firm's cost basis records, and the financial intermediary's.

In the past, any differences between cost basis tracking of the firm and cost basis tracking of the custodian were typically resolved in favor of the firm; after all, the firm could review the client situation in detail, and provide the necessary information for the client to support whatever was reported on the tax return. If the custodian's records indicated something different, it didn't really "matter" since that information was just voluntarily provided, and often the planning firm would simply inform/update the custodian on the correct cost basis details.

Now, however, the situation is different; the financial intermediary is the one that reports directly to the IRS, and consequently if there is a difference between the planning firm and the broker/custodian, the former must defer to the latter. Otherwise, if the client follows the firm and contradicts the broker/custodian, the client will file a tax return with numbers that don't match the Form 1099-B, increasing the risk of audit and subsequent adjustment back to what the intermediary reported anyway. As a result, the pressure is now on planning firms to ensure that *their* records match the custodian's, not the other way around.

Consequently, firms that continue to track cost basis for clients - even if primarily just to assist with noncovered securities - will need to make sure that their records match the custodian's records with respect to any covered securities. If there are differences, the firm must reconcile to match the custodian. This may also be crucial if the firm attempts to be tax-efficient in their investment process; if the firm's portfolio management software has the "wrong" cost basis for a covered security, they may engage in less desirable transactions (from a tax perspective), even though ultimately the client must report according to the custodian's records.

How might differences arise between the firm's cost basis tracking and the financial intermediary's? The most obvious situation would be where the firm's software is simply using a different cost basis methodology than the custodian - for instance, where the custodian uses the default FIFO for stocks and average cost for mutual funds, but the firm tracks differently. Alternatively, where the custodian tracks cost basis on an account-by-account basis but the firm's software aggregates cost basis lots across all accounts, discrepancies may arise. On an ongoing basis, differences could also arise if a wash sale occurs, which the custodian will track and adjust cost basis for the wash sale (at least if it's the same CUSIP in the same account), whereas few portfolio management software systems automatically track wash sales and adjust cost basis (and the firm might not catch it to make a manual adjustment). In addition, multiple purchases on the same day can create discrepancies if the default FIFO (or LIFO) methodologies are used, as the custodian may implement based on intra-day timestamps to determine which transaction was "first", while many portfolio management software packages do not track intra-day transaction times to calculate FIFO/LIFO appropriately.

Simply put, firms that track cost basis will likely want to engage in a regular reconciliation process between the firm's software and the custodian's own reports, to ensure the numbers are consistent. This is especially

Cost Basis Tracking Inside Retirement Accounts

Although the recent Treasury Regulations on cost basis tracking note that sales of securities in nontaxable accounts (e.g., IRAs) are exempt from cost basis reporting, many custodians have nonetheless been implementing cost basis tracking for *all* investments in *all* accounts, including retirement accounts (if only because it may be harder to create rules to exclude accounts than it is to simply track them all). Although there will be no Form 1099-B issued for transactions that occur inside retirement accounts (just a Form 1099-R for distributions *from* retirement accounts, as is standard), the fact the cost basis is being tracked creates a "risk" that the firm's records of cost basis will not match the custodian's.

This raises the question about whether firms need to worry about reconciling the cost basis information for client retirement accounts to the records with their broker/custodian, if the institution is in fact tracking cost basis inside *all* accounts. At this point, the answer appears to be no, as there are simply no rules currently in effect that require any information about the cost basis of assets held inside of retirement accounts (with the notable exception of employer stock held inside of a qualified plan that may be eligible to utilize the Net Unrealized Appreciation rules, but such accounts are typically already tracked by the qualified plan custodian and/or third-party administrator). And even if there were rules requiring tracking in the future, they would likely only apply to covered securities - in which case, the planning firm could simply use the IRA custodian's data at that time, since it would be binding anyway. Nor is there any apparent decision that a planning firm might make that would in any way be impacted by knowing whether a position held inside a retirement account happened to be high or low cost basis, anyway.

So the bottom line is that notwithstanding the reality that some financial intermediaries have made the decision to just track "everything", reconciling retirement account cost basis information simply doesn't matter right now (or for any foreseeable future).

true early in 2012, for the majority of firms that use mutual funds and ETFs, where any differences between reporting methods for a particular client or account will be highlighted the first time there is a partial sale transaction of a position that had multiple purchase lots.

Timeliness of Choosing a Method of Accounting

Historically, many clients have taken advantage of the opportunity to "wait and see" which lots they wanted to identify as sold (depending on whether they wanted to harvest gains or losses and minimize or maximize income in that particular year) until early in the following year after the sale, when the tax return and Schedule D was prepared. Once it was decided which lot sales would be most optimal for tax efficiency, the client (and/or planner) would simply go back after the fact to "update" the cost basis records for the shares that remained. While this was technically a violation of the regulations - which have always stipulated that the identification of which lots were sold is supposed to be done at the time of sale - it was virtually never caught or disputed, due to the lack of any way for the IRS to track down such misreporting or abuse.

Under the new rules, though, clients can no longer employ this approach, at least (or especially) with respect to any covered securities. Since the financial intermediary will report the gains and losses on any transactions involving covered securities on Form 1099-B according to the method of accounting on record at the time, clients no longer have the means to go back after the fact and try to alter which lots they claim were sold. In fact, the new Treasury Regulations on cost basis reporting make it clear that the identification of which lots are sold *cannot be changed* once the transaction settles; at best, the client and planner can intervene *at the time of sale* to specify which lots are sold or to change the method of accounting, but not after the fact. Once the sale settles, the financial intermediary's records will forever lock in which lots were identified as sold and the associated gain or loss.

As a result, it becomes far more important than ever to make an affirmative decision about which method of accounting to utilize, and to do so *before* the transaction occurs. No longer can clients push or abuse the rules by making a decision after the fact with impunity. A proactive decision in advance is required, and notably even the failure to make a decision is still a decision, as it will still mean the client has implicitly selected into the broker/custodian's default method of accounting, which in the case of mutual funds may *permanently* lock *all* of those shares into average cost accounting once a subsequent sale occurs!

Wash Sales

The new rules on cost basis reporting also present several practical challenges to be aware of with respect to wash sales.

First and foremost, any "blatant" form of wash sale - where the exact identical security is bought and sold in the same account - will automatically be reported as a wash sale by the financial intermediary on Form 1099-B. As a result, some clients (or their planners) may be startled to find they actually cause more wash sales than previously realized. For instance, any partial sale for a loss of a mutual fund that has monthly dividends that are reinvested may create a wash sale, either for the next dividend that is purchased/reinvested within 30 days after the loss sale, or for the last dividend that was reinvested *before* the loss sale. On the plus side, the wash sale will be calculated automatically and reported appropriately on Form 1099-B (at least with respect to covered securities); on the minus side, many clients previously avoided reporting such wash sales, if only because they didn't realize it was a wash sale that should have been reported in the first place. As highlighted earlier, this also creates complications for planners who track cost basis with their own portfolio management software, as many software programs do not accurately track wash sales, while the broker/custodian will be required to do so, creating a mismatch between the systems.

Some firms may decide to turn off dividend reinvestments because of these wash sale complications, and instead simply let their rebalancing software do the necessary repurchases from cash if/when the portfolio allocation falls out of balance. This may at least reduce the number of wash sales that occur, without necessarily causing a material distortion of the portfolio's long-term return (assuming the rebalancing thresholds that trigger purchases are reasonable). On the other hand, it's important to note that at the end of the day, a wash sale simply *defers* the recognition of the loss to a future date by adding the disallowed loss back to the cost basis of the new purchase; as a result, there is no *permanent* damage done when a wash sale occurs within a specified account. Accordingly, turning off dividend reinvestments to minimize wash sales will typically only be done for the purpose of simplifying the reconciliation of cost basis tracking between systems; it is not necessary to avoid economic harm, as the suspended loss still adds back to cost basis, and it is not necessary to simplify tax reporting (for covered securities), as the broker/custodian will still provide an accurate Form 1099-B for the client and his/her accountant to use when completing Schedule D, even if wash sales occurred.

On the other hand, it's important to remember that the financial intermediary is only required to report on wash sales that occur with *identical* securities repurchased within the *same* account, while ultimately the wash sale rules apply to any *substantially identical* securities that are repurchased within *any* account (including the individual's IRA, or the individual's spouse's account). Accordingly, the fact that the financial intermediary doesn't report a wash sale is no safe harbor for failing to track and report it directly. Clients and their planners still have an obligation to monitor for wash sales across the entire household of accounts, and report them accordingly. Furthermore, if wash sales do occur across accounts, or with securities that were not identical but are still substantially identical, the client and planner must manually adjust the cost basis tracking in their systems, *and* report the wash sale to the broker/custodian to update *their* cost basis and ensure that the Form 1099-B is not incorrect at the end of the year.

(*Editor's Note*: An exception to the "wash sales do no harm" rule is where the investment is sold for a loss in a taxable account and purchased back in an IRA, where the loss is *permanently* lost; on the other hand, such wash sales are still up to the client to disclose to the IRS {and the broker/custodian}, as the financial intermediary will not be required to track and report such wash sales automatically because the transaction spans across more than one account.)

Bringing It All Together

While in the long run, the new cost basis reporting rules will make it much easier to track exposure to capital gains/losses and reporting the results of completed sales, in the short-to-intermediate term the new rules make life more complex, especially for planners.

While for clients, there is a need to be aware of what is a covered vs noncovered security so that the latter can still be reported correctly on Schedule D, in the case of the planner there is pressure to track and report on noncovered securities on behalf of clients while simultaneously ensuring that covered securities match the records of the financial intermediary. The planner cannot simply use the financial intermediary's records - as those lack information on noncovered securities - but cannot blindly use their own records, as any conflict between the firm's cost basis and the custodian's for a covered security must be reconciled in favor of the custodian's data. And discrepancies may happen, especially early on, when the firm's portfolio management software might not match the method of accounting with the custodian for each and every client and account and investment position, and in any event transactions that produce wash sales may create discrepancies down the road if the software does not track it automatically (and at this point, it appears that most do not). In addition, some firms may find that their records are already out of sync with the financial intermediary in the case of stock positions, since those investments became covered securities at the start of 2011!

Beyond these operational issues, the biggest issue that clients face as the new rules are implemented is the decision about what cost basis method of accounting to use - especially with mutual funds becoming subject to the rules in 2012, with a default method of average cost that cannot be revoked once a sale of some of those shares occurs (although any existing shares subject to average cost that have experienced a sale are already locked in to that method). Overall, because lot identification *really* cannot occur during tax season now (regardless of the fact that it wasn't supposed to, even in the past), and must be determined by the time the transaction settles, the upfront decision about which method to choose is crucial, especially since the default methodology will not likely be preferable for most clients (whether average cost for mutual funds or FIFO for everything else).

And of course, which method of accounting to choose has complexity itself. Different financial intermediaries may offer different options; although all will likely offer the basic methods of accounting, not all have a tax-sensitive Highest Cost, for example, and some may have additional options not discussed here. Furthermore, merely picking a standard method that produces the smallest gains and biggest losses for all clients may also be undesirable, as some clients subject to 0% capital gains rates should actually choose the opposite method. Other clients, especially those with very high incomes, may prefer a Lowest Cost method simply to harvest capital gains rates at the current 15% maximum, before the maximum long-term capital gain rate lapses back to 20% in 2013, with a 3.8% Medicare surtax applied on top of that for high-income taxpayers.

Conclusion

In the end, the new reporting rules for cost basis tracking should make life a little simpler and easier for planners and their clients. At the point that virtually all clients hold only covered securities, planners will simply be able to rely on the cost basis information tracked by the financial intermediary, both to make investment decisions, and to support client tax reporting.

Until that point, though, a burden remains on planners to support clients regarding cost basis issues for existing (noncovered) investment positions. Furthermore, as the new rules phase in, planners must also work with clients to make an appropriate decision about which method of accounting to choose - bearing in mind that even no decision is effectively a decision to adopt the default method of FIFO (or average cost for mutual funds). And coupled with the looming rise in long-term capital gains rates in 2013, the decision is not so easy as to simply plan for the method that minimizes current tax exposure for clients. A client-by-client approach is necessary to ensure an optimal outcome.

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