

# Cost Basis: What's the Big Deal?

## Let's Party Like It's... 2011?

It's a brand new year and *The Emergency Economic Stabilization Act* of October 2008 (the "Bailout Bill") seems like a distant memory from a hazy and tumultuous past. However, the fallout from the bailout is still being felt, and the first date regarding changes to cost basis reporting (brokers and other financial intermediaries must report the cost basis on stock acquired by their clients on or after January 1, 2011) has passed with barely a blip.

As an investor, you might be saying, "So what? What is cost basis anyhow, and why should I be concerned?" Cost basis, tax basis, adjusted cost basis – whatever you call it – is probably the least of your worries right now! However, come tax time, if you aren't familiar with the concept of cost basis, the impact of the 2008 Bailout Bill on cost basis, and the consequences of misreporting cost basis and gain/loss, not only will you be concerned, but you may well be sending up emergency flares.

## Cost Basis Basics

When you sell a security, such as shares in a company or a mutual fund, you must report the capital gains as taxable income. Capital gains are the difference between what you paid for the security

and what you sold it for. What you paid for the security (plus the commission) is called the "cost basis." The more you paid for the security, the less your gain when you sell it.

Sometimes it is easy to figure out the cost basis, especially if you recently acquired the security and then sold it shortly thereafter. The basic cost basis calculation for stock is (# of shares) x (price paid per share). This calculation is something you could do yourself on a calculator!

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By the way, a purchase of shares is called a "tax lot." This is a term you need to know when it comes time to sell your securities. If you have made several purchases of the same security, each of these purchases is considered a tax lot by the IRS for the purposes of taxation. Each tax lot has its own cost basis.

## This Doesn't Sound So Complicated....

Now for "adjusted cost basis." This is the cost basis of a security adjusted for the effects of corporate actions such as mergers, spin-offs and stock splits. Something that most people don't realize is that if you have owned the security for many years, the complexity of its corporate history can make the adjusted cost basis much more difficult to calculate. For example, if you have held shares in a company for several years or more, chances are the stock has split, or part of the company has been spun-off, or the company merged with another company. As you know, today's business environment is such that companies are merging all the time. For example, if you own airline stock, chances are the company name on your stock is not the same as what you originally started out with! Ditto for stock splits; if the number of shares you own has changed due to stock splits, then the cost basis per share has changed too.

Dividend Reinvestment Plans and Systematic Investment Plans are other complicating factors. If you decide to reinvest your dividends, then in effect, every time the company issues a dividend (usually four times a year), you have just made another purchase with a

different cost basis than the shares you originally purchased. If you have been reinvesting your dividends for ten years, then you will have forty different purchases (also called tax lots) in addition to your original investment, each with a different cost basis. The same goes for Systematic Investment Plans; if your plan has you acquiring shares every other month and you've been doing it for ten years, then you have sixty tax lots, each with a different cost basis.

Are you getting that sinking feeling yet?

It can also be challenging to determine the adjusted cost basis of inherited or gifted shares, where historical information may be sparse or nonexistent. If your late Uncle George left you with 100 shares of XYZ Corp., XYZ Corp. might not even exist under that name anymore, and those 100 shares might actually be 500 shares of something else by now. You sure would like to sell the shares and use the money for your daughter's college education. Now what?

### Now What Indeed!

Cost basis is not new. Investors and financial professionals have always had to figure out the cost basis when a security is sold in order to arrive at the capital gain or loss figure reported on the Schedule D form.

Fortunately in the past brokers have provided the gain/loss amount on the 1099 Form and investors could just transfer that amount over to their Schedule D. Where investors have taken it upon themselves to calculate their own cost basis, they use a calculator, a spreadsheet and a

lot of coffee, or they use a program such as Netbasis® to accurately calculate the amount. Many people simply “guess-timate” the cost basis of their security, thus bypassing the potentially time-consuming and complicated machinations required to come up with an accurate cost basis figure and at the same time, desperately hoping that the IRS doesn't notice.

Well, the IRS noticed. They realized that, as a result of misreported cost basis, many taxpayers were under-reporting capital gains and thus underpaying their taxes. So now the IRS is interested in how you arrived at your gain/loss figure.

In 2005, the IRS released results of the *2001 National Research Program* audit of 46,000 taxpayers, in which Netbasis® technology was used as a verification tool for cost basis information. The IRS determined that a tax gap of between \$6 billion and \$9 billion per year existed due to under-reported capital gains. The tax gap is the difference between what taxpayers should pay and what they actually pay. So now the IRS wants to know what cost basis amount you and your broker are using to come up with that gain/loss amount. The result is the new cost basis reporting regulations and its fallout for the average individual investor, which is estimated to raise \$6.67 billion for the federal government over ten years.

The new legislation, called *The Emergency Economic Stabilization Act of 2008* – popularly known as the “Bailout Bill” – was signed into law on October 3, 2008 to address the mounting global financial crisis. Recalling that tax gap, Section

403 of the Act contains provisions that place significant cost basis-related requirements on individual investors, who must report the correct cost basis on the Schedule D Form (more about that later).

Under the new legislation, brokers, banks and other financial intermediaries must report accurate adjusted cost basis information to the investor on Form 1099-B for:

- Equities acquired on or after January 1, 2011
- Mutual fund and dividend reinvestment plan (DRiP) shares acquired on or after January 1, 2012
- Financial instruments such as debt securities, options and private placements acquired on or after January 1, 2013.

### So How Will This Affect Me?

**Good News:** This year and going forward, when you fill in your Schedule D to report the sale of stock, you will see that the IRS now requires a new piece of information: cost basis.

In theory, this year you ought to be able to continue to refer to the 1099-B form provided by your stock brokerage firm and transfer over the cost basis figure to the Schedule D.

**Not So Good News:** Brokers aren't required to report cost basis on stock purchased before January 1, 2011, but you are. (these are called “uncovered” securities; anything purchased on or after January 1, 2011 is called a “covered” security). The government is giving financial intermediaries a break and giving them some time to catch up.

<b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
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financial intermediaries, such as brokers: up to \$350,000 per year for incorrect Form 1099-B cost basis reporting and unlimited penalties for intentional disregard of

**A new column on the Schedule D**

As a result, brokers are not required to – and, with the exception of some very customer-service oriented firms, possibly won't – report the cost basis on uncovered equities, those purchased before January 1, 2011. If you sold stock last year, that stock was an uncovered equity. Many taxpayers reporting cost basis for sales of stock purchased before January 1, 2011 will have to calculate their own cost basis, because if their broker didn't provide it, that's no excuse for the IRS; the tax payer must still report it.

If your broker has provided you with the cost basis for stock purchased before January 1, 2011, you should be wary of the legal responsibility placed upon you by the IRS to ensure that the cost basis you report on your Schedule D is correct. Don't take comfort in the fact that your broker has given you the cost basis amount; you should be double-checking that figure because if it's wrong, you are subject to fines.

This goes for your accountant or tax preparer as well. You need to know exactly how your accountant is calculating cost basis and make sure he or she understands the consequences to you and

other customers of misreporting cost basis. For example, some accountants simply take an average... an average of what? A selection of prices throughout the history of your holding? With the basic understanding of cost basis that you've achieved by reading this report, even you know that's not right!

Remember that "almost" or "approximately" is not good enough for the IRS anymore and the responsibility is in your hands to make sure your tax professional is calculating your cost basis and gain/loss properly!

**Did You Say, Legal Responsibility?**

Ah, you noticed. Yes, we said "legal responsibility" and "fines."

Taxpayers are subject to penalties of up to \$1,000 for under-reporting capital gains, and up to \$5,000 for willful disregard of the law or reckless conduct in reporting capital gains. "Willful disregard" means you didn't even attempt to come up with an accurate cost basis amount; you simply pulled a number out of thin air.

The stiffest penalties for noncompliance with the new cost basis reporting law are for

the new requirements. You should know that, in general, the government is paying new and focused attention on non-compliance. We are now living in an "era of compliance." For example, the IRS is making sure taxpayers are complying with wash sale rules. A wash sale is when you purchase a stock, sell it at a loss, and then buy it again within 30 days of the sale. Because of the wash sale rule, you cannot claim a loss on the sale of the stock if you buy stock to replace what you just sold within 30 days of the sale. People who break the wash sale rule usually do so unintentionally, but the IRS is going to be watching now to make sure no one breaks this rule. You need to track the dates of your sales and purchases to ensure you don't violate the wash sale rule.

**You can STILL Pay Less in Taxes!**

Yes, there is some more good news, but again, in order to take advantage of the good news you need to be a more involved investor than perhaps you have been in the past.

The cost basis legislation now permits taxpayers to choose

from a variety of sales methods for each tax lot sold. Remember that a tax lot is a purchase of a security. If you purchased the same stock four times over the past two years, each of those four purchases would be considered a separate tax lot, each with its own cost basis.

When brokers report the cost basis for a sale of a security on the 1099-B Form, they will use the FIFO (First-In, First-Out) method as the default, meaning that the tax lot you've owned the longest will be the one that is sold first. Tax-wise, using FIFO may not always be in your best interest.

However, you can now specify to your broker the sales method to use to give you the desired gain/loss and, thus, the corresponding tax effect. You have three days from the date that the stock was sold until the settlement date, during which time you can ask your broker to choose a different sales method, including the Specific method, which allows you to select the specific tax lots to sell.

You now have the power to decide, but the onus is on you to inform your broker of the sales method you wish to use.

### **The Light at the End of the Tunnel: Netbasis®**

By now you are probably thinking that you should retire your calculator (if in fact you ever used one in the first place), second-guess your broker and your accountant, and find some serious cost basis tools. We have an answer for you: Netbasis®.

A powerful web-based application, Netbasis® is more than just a "cost basis calculator." For example,

Netbasis® determines the cost basis of a security, no matter how complicated its history, in less time than it takes to send an email. Netbasis®' database of securities information goes back to 1925, and automatically accounts for all splits, mergers and spin-offs. It also catches wash sales and short sales. Simply enter basic details into Netbasis®' easy-to-use web pages, and Netbasis® produces all the information required to complete your Schedule D form.

Netbasis® is an ideal tool for people who have received securities as a gift or an inheritance and have sold some or all of the securities. With just a few pieces of information Netbasis® can calculate the value of the security, the original owner's cost basis, and the recipient's expected gain or loss.

Now that you can inform your broker as to which sales method to use, the question is: Which tax lots to sell? The Netbasis® Tax Optimization tool provides a powerful "what if" scenario feature that lets you enter your objectives – gain or loss amount, short term or long term gains, and proceeds. Based on these parameters, Netbasis® will suggest which tax lots could be sold to meet your objectives. The results are provided on a detailed report that is simple to interpret and analyze. You can then change your objectives, enter new parameters and view the outcome, trying out different scenarios as many times as needed to get the results you want.

Accessing Netbasis® is as simple as going to the Netbasis® website [www.netbasis.com](http://www.netbasis.com). There you will find a lot more information about the Netbasis® application, including the new

question-and-answer cost basis program, Netbasis® Wizard. To use Netbasis®, just click on the **Buy Now** button – no complicated downloads or software installation required. If you want to speak to a human first, contact a Netbasis® sales professional at [info@networthservices.com](mailto:info@networthservices.com) or call 1-888-95-BASIS. We'd love to talk to you!

### **Be Prepared**

In summary, your motto for this year should be that age-old adage: *Be Prepared*. Find out about cost basis before April 17 (FYI, the deadline for filing this year has been extended to April 18, 2011). Understand what information your broker is providing. Inquire how they calculated the cost basis. Find out if they will provide you with the cost basis of uncovered equities. Talk to your accountant about how they calculate cost basis. If you are not confident in their answers, suggest they try out Netbasis®, or tell them you will do your own cost basis calculation. Remember, the person who is ultimately responsible for the accuracy of your cost basis is: YOU.

### **For More Information:**

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