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## Rules Address Reporting of Securities Transactions

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A stockholder who purchases stock on different dates or with different prices and then sells a portion of the stock may use a number of methodologies to determine the basis and holding period for the shares sold. One method is “first in first out,” with the shares sold being deemed to have been from the earliest lots acquired for purposes of determining the amount of gain or loss and the holding period.

Alternatively, if the lots from which the stock was sold are adequately “identified” at the time of the sale, the shares specifically identified will be considered to be the shares sold. Finally, owners of shares in a regulated investment company (“RIC”) such as an open-end mutual fund have long been permitted to use various methodologies under which basis is determined by reference to the taxpayer’s average basis in all shares owned in the fund.

The recordkeeping burden and complex computations involved in tracking and computing basis and holding periods (under these general rules and numerous exceptions and special rules) are potentially quite complex and difficult and likely beyond the capabilities of many investors.

In order to assist taxpayers in making these calculations and the Internal Revenue Service in auditing them,<sup>1</sup>

amendments made to the Internal Revenue Code (“IRC”) by the Emergency Economic Stabilization Act of 2008 require that information concerning the adjusted basis of securities acquired through a broker on or after January 1, 2011, and regarding whether any gain or loss from the sale is long-term or short-term, must generally be provided by the broker to the taxpayer and to the IRS. These rules supplement a longstanding requirement that brokers must report the “gross proceeds” of sales of securities that they effect on behalf of customers.

Under the same legislation, a person who transfers securities to a broker is required to provide certain information necessary to permit the broker to comply with the basis reporting requirements; and each issuer of specified securities is required to file a return with respect to any organizational action that affects the basis of those securities, describing the action that was taken and its effect on the basis of the specified security.

Earlier this month the IRS issued final regulations implementing these requirements, together with a notice that provides transitional relief to brokers and custodians with respect to reporting certain transfers of stock to other brokers in 2011.<sup>2</sup> The regulations are extraordinarily lengthy and complex. Certain salient features of the final regulations are discussed below, with a focus on provisions likely to be of the greatest interest to issuers and owners of securities.

### New Regulations

The new rules impose additional reporting obligations on brokers and other persons who act as middlemen with respect to the “sale” of a “covered security”. A “sale” for these purposes is a disposition of securities for cash.

A “covered security” is, generally, a “specified security” acquired after an “applicable date” (further discussed below) no earlier than January 1, 2011. The term “specified security” includes any share of stock in a corporation, including interests treated as stock in an entity which may be organized under local law other than as a corporation, but which is treated for Federal tax purposes as a corporation, and including depositary receipts (ADRs) representing shares of stock in a foreign corporation. For now, the new reporting requirements with respect to basis apply only with respect to stock.<sup>3</sup>

Stock granted by an employer to an employee is not a “covered security” because it is not acquired for cash. However, stock acquired in a corporate transaction such as a stock dividend or recapitalization is generally treated as a covered security (even if no cash is paid) if the basis of the stock received is determined by reference to the basis of a covered security.

The “applicable date” for purposes of the new rules is generally January 1, 2011, with respect to stock of a corporation, except for stock for which an average basis method is permitted. With respect to stock for which an average

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basis method is permissible, the “applicable date” is January 1, 2012; and, for all other securities, the applicable date will be no earlier than January 1, 2013.

Use of the “average basis method” described in the new regulations (which averages the basis of all identical shares in an account regardless of holding period) is permitted, generally, if the taxpayer deposits (i) shares of stock in a regulated investment company (“RIC”), or (ii) shares of stock acquired after December 31, 2010, in connection with a dividend reinvestment plan, with a custodian or agent in an account maintained for the acquisition and disposition of shares of stock. In general, basis is to be computed under an account-by-account approach with respect to any sale of a specified security on or after the “applicable date”.

With respect to use of the average basis method, stock in a fund that is acquired before January 1, 2012, is generally treated as a separate account from stock acquired on or after that date. A fund may elect, however, to treat all stock held in a fund as covered by the new rules relating to the average basis method regardless of when the stock was acquired.

The additional information regarding adjusted basis with respect to sales must generally be provided to customers by brokers no later than February 15 of the calendar year following each sale. Historically, sales effected by certain categories of customers, including corporations, have been exempt from such reporting. Under the statutory amendments and new regulations, however, sales by S corporations will generally be subject to information return reporting.

The regulations require that the broker take into account the conventions under IRC section 1012 in determining basis and gain or loss realized, as well as other relevant rules such as the special rules relating to property acquired by gift. Section 1091, which disallows losses with respect to wash sales, must be taken into account by the broker where the securities are purchased and sold from the same account. The re-

porting must also take into account adjustments for undistributed capital gains of a RIC or real estate investment trust (“REIT”) taxed to the customer and reported to or by the broker.

However, a broker is not required to apply IRC provisions such as section 1259 (constructive sales) or section 475 (mark-to-market method of accounting) or certain other special rules relating to RICs and REITs, in reporting adjusted basis; nor is the broker required to apply the rules under IRC sections 1092 and 1233 or Regulation section 1.1221-2, relating to straddles, hedging transactions, and offsetting positions, in determining the character of gain or loss with respect to a sale of a security.

In reporting the basis of stock purchased upon exercise of a compensatory option or from an employer in a compensatory transaction, a broker may, but is not required to take into account in 2011 or 2012 compensatory income resulting from the exercise of the option or the vesting of restricted stock acquired subject to a substantial risk of forfeiture.

Although the new reporting requirements relating to stock basis are generally applicable for stock acquired beginning in 2011, stock in a RIC with respect to which the average basis method is available, or stock acquired in connection with a dividend reinvestment plan, is generally considered to be a covered security only if acquired on or after January 1, 2012.

#### **Transfer Statements**

A broker or other middleman that is subject to the requirements to provide information returns relating to security sales, and that transfers a covered security to another broker must furnish a transfer statement, within 15 days after the date of settlement of the transfer, with information regarding the security transferred, including the adjusted basis and acquisition date. These rules apply, for example, where the owner of shares held in an account with a broker causes the shares to be transferred to an account of that owner with another broker, or to the account of another person as a gift.

Notwithstanding that the transfer statement requirements are generally effective beginning in 2011, IRS Notice 2010-67 provides that, except in limited circumstances relating to cash on delivery accounts and multiple broker arrangements, the IRS will not assert penalties for a failure to provide a transfer statement for any transfer of stock in 2011. Also, a receiving broker may treat stock transferred to it in 2011 as a security not covered by the new basis reporting rules.

#### **Issuer Statements**

An issuer of a covered security that completes an organizational transaction that affects the basis of the security, such as a stock split, distribution of stock, or distribution of cash to shareholders that exceeds earnings and profits (such that at least a portion of the distribution is not a dividend), must file an issuer statement with the IRS by the 45<sup>th</sup> day following the organizational action, or, if earlier, by January 15 of the year following the calendar year of such action.

The issuer statement must disclose information including the identity of the issuer, identification of the securities involved, the date and nature of the organizational action, and the quantitative effect of the action on the basis of the security as an adjustment per share or as a percentage of the old basis, including the provision of the IRC on which the adjustment is based, data supporting the calculation of the adjustment, and whether any resulting loss may be recognized.

Reasonable assumptions may be made about facts that cannot be determined by the due date, but a corrected return may be required if the assumptions prove incorrect in a manner that affects the basis adjustment.

The same information is generally required to be provided to each holder of record of a security or the holder’s nominee, on or before January 15 of the calendar year following the calendar year of the organizational action.

This requirement may be met in certain circumstances by posting a statement with the required information

on a web site of the issuer. The requirement is deemed to be met with respect to an S corporation if the effect of the organizational change is reported on a timely filed Schedule K-1 for each shareholder.

The requirement to furnish an issuer statement is generally effective beginning in 2011, but does not apply until 2012 with respect to RICs.

The preamble to the final regulations (T.D. 9504) notes that, in many cases, the basis reported by a broker under these new rules may not reflect the taxpayer's actual basis in the shares sold. Taxpayers are expected to use the

correct basis in computing gain or loss on their tax returns, regardless of amounts reported by brokers. The preamble also states that the IRS is in the process of revising the tax return forms and related instructions to facilitate reconciliation with the new broker reporting.

Much effort will be required for brokers to establish systems needed to comply with the new rules relating to the computation and reporting of adjusted basis and character of gain or loss, and those systems may not be 100% reliable especially in the first years of compliance.

In addition, issuers of securities will have to be alert to the need to provide the required issuer statements with respect to organizational actions in a timely manner, and stockholders and their advisors will have to review with care the expanded information to be provided to them under these regulations, to ascertain whether or not the expanded Form 1099-B's they receive reflect accurate calculations of basis and correct characterizations of gain or loss in the stockholders' specific circumstances.

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<sup>1</sup> See Joint Committee on Taxation Report (JCX-75-08) relating to the Emergency Economic Stabilization Act of 2008 (P.L. 110-343, Oct. 3, 2008), under the caption "Explanation of Provision – In general".

<sup>2</sup> T.D. 9504 (Oct. 12, 2010); IRS Notice 2010-67, 2010-43 IRB \_\_ (Oct. 12, 2010).

<sup>3</sup> The IRS is authorized to expand the basis reporting requirements to any note, bond, or other evidence of indebtedness, and any commodity, contract or derivative with respect to a commodity, or other financial instrument with respect to which it determines the requirements are appropriate.

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