

Chapter 4:

Cost Basis Reporting for Security Sales

The Energy Improvement and Extension Act of 2008 amended IRC sec. 6045 to mandate that every broker required to file a Form 1099-B with the IRS reporting gross proceeds from the sale of a covered security ***additionally report a customer's adjusted basis in the security*** and whether any gain or loss on the sale is classified as short-term or long-term. The ***2011 Form 1099-B contains new boxes for reporting this information***. This new reporting requirement puts the burden on brokers to obtain accurate cost basis for the securities they hold. To assist in the maintenance of cost basis records and the calculation of gain or loss on sale, the new law:

- Directs brokers to ***follow customers' instructions and elections*** when determining adjusted basis.
- ***Establishes new rules for conventions and methods*** to determine cost basis of specific shares sold.
- Provides that when a broker transfers securities to another new broker before their sale, the ***transferring broker must furnish a statement to the receiving broker*** containing sufficient information about the transferred securities for the receiving broker to determine the customer's adjusted basis and whether any gain or loss is short-term or long-term when the transferred security is eventually sold.
- Requires brokers to ***report short sales on a Form 1099-B for the year in which the short sale is closed***, rather than the year in which the sale occurs to open the short position.
- Requires brokers to ***adjust basis to reflect wash sales***. This requirement only applies if the acquired securities are identical (instead of substantially identical) to the sold securities. Moreover, wash sale tracking is required only when the purchase and sale transactions occur in the same account.
- Extends 1099-B basis reporting to sales from brokerage accounts owned ***by S corporations***, effective for stock acquired ***after 2011***.
- ***Requires issuers of securities to file a return*** with the IRS and furnish a statement to holders of the securities after taking a ***corporate action that affects the basis*** of the security to explain the corporate action and its quantitative effect upon the basis of the security.

The law also makes ***substantive changes in the way the cost basis of mutual fund shares and stock acquired through a dividend reimbursement plan may be calculated***. These changes include:

- Allowing the use of ***average basis*** for shares of stock acquired through a ***dividend reinvestment plan***.
- Allowing taxpayers to ***elect average basis*** for mutual funds on an ***account-by-account basis***.
- Eliminating the use of the ***double-category average basis*** calculation method.
- ***Binding the taxpayer to the broker's method of basis determination*** upon a sale of shares, absent a specific election of a method by the taxpayer.

The IRS has changed both the 1099-B and the Form 1040 Schedule B, in ways that underline the fact that basis as reported by the brokers is going to be presumed to be the basis of the securities sold. Copies of the **new 1099-B**, along with the revised Schedule D and the new **Form 8949** which replaces the old Schedule D-1 are included on the following pages.

The IRS has issued three sources of guidance from which the material that follows is drawn:

- *Final Regulations under secs. 1012 and 6045* (TD 9504 10/1/2010)
- *Notice 2011-56* (6/21/2011)
- *IRS Website Cost Basis FAQs* (3/7/2011)

Effective Date

When do these reporting requirements go into effect?

- For stock in a corporation, the applicable date is January 1, 2011.
- For shares of a mutual fund and stock held in a dividend reinvestment plan (DRP), the applicable date is January 1, 2012.
- For any other specified security, the applicable date is January 1, 2013 or a later date determined by the Secretary of the Treasury.

Terminology:

- A security for which the *new rules are in effect at the time it is acquired* is called a “covered security”.
- A security for which the *rules are not in effect at the time it is acquired* is called a “noncovered security.”

Are securities acquired by businesses covered?

- Securities acquired by *partnerships* are covered securities if bought after the applicable date.
- Securities acquired *by S corporations* are covered securities if bought after 2011, or after the applicable date, if later.
- Securities acquired by *C corporations* are never covered

Is a broker required to determine whether a corporate customer is an S corporation or a C corporation? If so, how?

- A broker must determine whether its customer is an S corporation or a C corporation, but only for sales of covered securities acquired *on or after January 1, 2012*.
- If a broker has no actual knowledge of whether a corporate customer is a C corporation, the broker *must request a Form W-9* exemption certificate. If the broker does not receive a Form W-9 it must assume that the corporation is an S corporation.
- A broker is not permitted to make a determination about corporate status for this exception solely based on the name of the business.

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Date of sale or exchange	OMB No. 1545-0715 2010 Form 1099-B	
		1b CUSIP no.		
		2 Stocks, bonds, etc. \$	Reported to IRS } <input type="checkbox"/> Gross proceeds } <input type="checkbox"/> Gross proceeds less commissions and option premiums	
PAYER'S federal identification number	RECIPIENT'S identification number	3 Bartering \$	4 Federal income tax withheld \$	
RECIPIENT'S name Street address (including apt. no.) City, state, and ZIP code		5 No. of shares exchanged	6 Classes of stock exchanged	
		7 Description		
		8 Profit or (loss) realized in 2010 \$	9 Unrealized profit or (loss) on open contracts—12/31/2009 \$	
CORPORATION'S name		10 Unrealized profit or (loss) on open contracts—12/31/2010 \$	11 Aggregate profit or (loss) \$	
Account number (see instructions)		12 If the box is checked, the recipient cannot take a loss on their tax return based on the amount in box 2 . . . <input type="checkbox"/>		

Proceeds From Broker and Barter Exchange Transactions

Copy B For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-B** (keep for your records) Department of the Treasury - Internal Revenue Service

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Date of sale or exchange	OMB No. 1545-0715 2011 Form 1099-B	
		1b Date of acquisition		
		2 Sales price of stocks, bonds, etc. \$	Reported to IRS } <input type="checkbox"/> Sales price } <input type="checkbox"/> Sales price less commissions and option premiums	
PAYER'S federal identification number	RECIPIENT'S identification number	3 Cost or other basis \$	4 Federal income tax withheld \$	
RECIPIENT'S name Street address (including apt. no.) City, state, and ZIP code		5 Wash sale loss disallowed \$	6 If this box is checked, boxes 1b, 3, 5, and 8 may be blank <input type="checkbox"/>	
		7	8 Type of gain or loss Short-term <input type="checkbox"/> Long-term <input type="checkbox"/>	
		9 Description		
Account number (see instructions)		10 Profit or (loss) realized in 2011 on closed contracts \$	11 Unrealized profit or (loss) on open contracts—12/31/2010 \$	14 Bartering \$
CUSIP number		12 Unrealized profit or (loss) on open contracts—12/31/2011 \$	13 Aggregate profit or (loss) on contracts \$	15 If box checked, loss based on amount in box 2 is not allowed <input type="checkbox"/>

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Form **1099-B** (keep for your records) Department of the Treasury - Internal Revenue Service

**SCHEDULE D
(Form 1040)**

Capital Gains and Losses

OMB No. 1545-0074

2011
Attachment
Sequence No. **12**

Department of the Treasury
Internal Revenue Service (99)

▶ **Attach to Form 1040 or Form 1040NR.** ▶ **See Instructions for Schedule D (Form 1040).**
▶ **Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.**

Name(s) shown on return

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

Note: Please round and use whole dollars on this form.	(e) Sales price from Form(s) 8949, line 2, column (e)	(f) Cost or other basis from Form(s) 8949, line 2, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		()		
2 Short-term totals from all Forms 8949 with box B checked in Part I		()		
3 Short-term totals from all Forms 8949 with box C checked in Part I		()		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h)				7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

Note: Please round and use whole dollars on this form.	(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		()		
9 Long-term totals from all Forms 8949 with box B checked in Part II		()		
10 Long-term totals from all Forms 8949 with box C checked in Part II		()		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back				15

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2011

Basis Determination Rules

In General: If a customer sells less than his or her entire position of a security in an account, a broker must report a customer's adjusted basis in the security (other than mutual fund or DRP stock) using the ***first-in, first-out (FIFO) method***, unless the customer provides the broker an adequate and timely identification of the shares or units the customer wants to sell.

A broker must report the adjusted basis of ***mutual fund or DRP stock*** (for which a customer may average the basis of the stock) ***in accordance with the broker's default method*** unless the customer notifies the broker that the customer elects a different permitted method.

Comment: Schwab has announced that its default method for mutual fund shares will be average cost.

The amendments ***change how taxpayers determine the average basis*** of mutual fund stock and permit taxpayers to average stock held in a DRP.

- ***Starting in 2012***, taxpayers who elect to average the basis of mutual fund shares will compute ***separate averages for fund shares held in different accounts***.
- Taxpayers also will be permitted to ***average the basis of mutual fund shares in one account but not average them in another account***.
- Further, unless the fund or broker holding the fund shares elects otherwise, taxpayers will compute a ***separate average for fund shares in an account that are covered securities*** and a ***separate average for fund shares in an account that are not covered securities***.

How must a broker determine basis when a sale includes securities acquired on different days or at different prices?

Specific Identification of Securities Sold: If a customer acquires securities on different days or at different prices and sells less than the entire position in an account, a broker must report the sale consistently with the ***customer's identification of the security*** to be sold if the customer provides the broker an adequate and timely identification.

When must taxpayers elect specific identification as their lot selection method?

- Taxpayers must identify stock sold by the ***earlier of the settlement date or the time for settlement*** under SEC regulations.

Can a taxpayer use a standing order to specify a lot selection method?

- Yes. A broker may permit a taxpayer to identify lots to be sold by a standing order.

Is there any specific way that a taxpayer must communicate a lot selection?

- No. In order to enable the greatest flexibility to taxpayers, ***there is no specific method designated by the regulations for communicating a lot selection***.

Are brokers still required to provide a customer with written confirmation of the sale of specifically identified stock? If so, is a broker permitted to communicate the required confirmation of sales of specific stock to a taxpayer electronically?

- Yes. The written confirmation requirement still applies. The regulations require brokers to provide written confirmation of the sale of stock which a customer specifically identified.
- *Electronic confirmation satisfies the "written confirmation" requirement.*
- The regulations also provide that *account statements and other periodic account documents satisfy the written confirmation requirements* if provided within a reasonable amount of time following a sale or transfer.

How is specific identification achieved in an estate or trust?

- A trustee of a trust or executor of an estate satisfies the specific identification requirements if he specifies the stock in writing in the books and records of the estate or trust. If the stock is distributed, the trustee or executor must identify the stock in writing to each distributee.

No Specific Identification of Securities Sold: If the taxpayer does *not* specifically identify the shares sold, the broker determines the shares as follows:

If the securities are *other than mutual fund or DRP stock*, the broker must:

- *first* report the sale of any *shares or units in the account for which the broker does not know the acquisition date*,
- *then* report the earliest shares or units acquired (**FIFO**), whether covered securities or noncovered securities.

If the securities are *mutual fund or DRP stock*, the broker must report adjusted basis in accordance with its *default method* unless the customer notifies the broker that the customer elects a different permitted method.

Note: The *double category method* for computing the cost basis of mutual fund shares is *eliminated* effective on April 1, 2011. For mutual fund shares held as of that date for which that method was previously used, the basis of the shares is computed by averaging the basis of all identical stock in an account regardless of the holding period.

Use of Average Basis Method for DRP Stock Under prior law, taxpayers were permitted to use the average basis method to determine the basis of stock in a regulated investment company (e.g., a mutual fund). The Energy Improvement and Extension Act of 2008 amended sec. 1012 to allow taxpayers also elect to use the average basis convention for stock acquired after *12/31/2010*, in connection with a *dividend reinvestment plan*.

Does a DRP need to be administered by an issuer for the average basis method to be permissible?

- No. The regulations define a DRP as a *written arrangement, plan or program* administered by an issuer *or non-issuer* of stock. Accordingly, a taxpayer may elect the average basis method for a DRP administered by someone other than a security's issuer.

Do all dividends have to be reinvested for securities to qualify as a DRP?

- No. The regulations only mandate that a DRP's plan documents require that *at least 10% of every dividend paid* be reinvested in identical stock.

Will transfers of identical stock into a DRP be considered part of a DRP?

- Yes. Stock acquired in connection with a DRP includes the stock initially purchased in the DRP, *identical stock subsequently transferred into the DRP*, additional periodic purchases of identical stock through the DRP, and all identical stock acquired through reinvestment of dividends or other distributions paid by the DRP.
- However, identical shares *do not include shares that are acquired but not then enrolled in the DRP*.

- **Example:** In 2011, Taxpayer C acquires 100 shares of H Company and enrolls them in a dividend reinvestment plan administered by T Custodian.
 - C elects to use the average basis method for the shares of H Company enrolled in the dividend reinvestment plan.
 - T also acquires for C's account 50 shares of H Company and does not enroll these shares in the dividend reinvestment plan.

Result: The 50 shares of H Company not in the dividend reinvestment plan are not identical to the 100 shares of H Company enrolled in the dividend reinvestment plan, even if they have the same CUSIP number.

- Accordingly, C may not average the basis of the 50 shares of H Company with the basis of the 100 shares of H Company.

If a DRP is terminated or the taxpayer withdraws his or her stock from the DRP, is the average basis method election still available?

- No. After termination of a DRP, or withdrawal of a taxpayer's stock from a DRP, a taxpayer may no longer elect the average basis method. However, the basis of each share of stock immediately after the change is the same as the basis immediately before the change.

Average Basis Election Timing/Mechanics: Although taxpayers can use the average basis method for DRP shares acquired in 2011, *brokers are not required to use this method for reporting purposes (for either DRPs or mutual funds) until 2012.*

- For DRP stock acquired in 2011, a taxpayer makes an *election* to use the average basis method on the taxpayer's *2011 income tax return*.
 - The election can be made on an amended return filed no later than the time prescribed (including extensions) for filing the original 2011 return.
- Starting *in 2012*, a taxpayer elects the average basis method by *notifying his or her broker of the election in writing*.
 - A taxpayer may make a written average basis election electronically.
 - The regulations provide that a taxpayer may elect the average basis method at any time.

- The election takes effect for sales that occur after the election.

Revocation: A taxpayer that wants to revoke its average basis method election may do so *retroactively* within *one year* after making the election or, if earlier, by the date of the first disposition of the stock. A broker may extend the one-year period, but not beyond the first disposition of the stock. After a revocation of the election, the basis of the stock reverts to the cost basis.

Once the revocation period has expired, a taxpayer may *change from the average basis method* to the cost method at any time, but only *prospectively*, for stock acquired after the date of the change. After the change, the basis of the stock that was averaged remains averaged.

Change from Broker Default Average Basis Method: If the taxpayer did not elect the average basis method, but the broker uses this as its default method for computing cost basis for mutual fund or DRP stock, *the taxpayer must request a change to the cost basis*. To be retroactive, this request must be filed by the earlier of one year after receiving notice of the broker's default method, or the date of the first sale, transfer, or other disposition of the stock. A broker may extend the one-year period, but not later than the date of the first sale, transfer, or disposition of the stock.

To determine the beginning of the one-year period, a broker using the average basis method as a default method must use reasonable means to notify taxpayers. Reasonable means may be mailings, circulars, or electronic mail sent separately or included in a taxpayer's account statement, or other means reasonably calculated to provide actual notice. The notice must identify the securities subject to the broker's default average basis method.

Other Average Basis Method Issues:

If a taxpayer owns shares of the same mutual fund in different accounts, can he or she make an average basis election for only some of the accounts?

- Yes, but only *after December 31, 2011*. Starting in 2012, a taxpayer may elect to average basis for a particular mutual fund in one account but not in another account.

How is an average basis determined for mutual fund or DRP stock when some of the shares are covered securities (post-2011) and some are noncovered (pre-2012)?

- Beginning in 2012, the regulations treat mutual fund and DRP stock that is a noncovered security as being **held in a separate account** from stock that is a covered security.
- Because stock is **averaged on an account-by-account basis** starting in 2012, the basis of shares that are covered (i.e., post-2011) securities will be the average basis of only the covered securities and the basis of the shares that are noncovered (i.e., pre-2012) securities will be the average basis of only the noncovered securities.

- However, if a broker has accurate basis information for shares that are noncovered (pre-2012) securities and makes a "**single-account election**" for some or all of the shares, the shares subject to the single-account election are treated as covered securities and their basis is averaged with the shares that are covered securities.

Brokers may make the single-account election only for noncovered mutual fund or DRP stock for which they have accurate basis information. Must a broker know whether a taxpayer previously averaged mutual fund or DRP stock held by the broker?

- Yes. Accurate basis information includes whether the basis of stock held by the broker previously was averaged by the taxpayer.
- A taxpayer makes the average basis method election for noncovered mutual fund or DRP stock on the taxpayer's return and, for stock sold before 2012, must average the basis of all identical stock *held in any account*.
- Therefore, a broker should exercise caution in making a single-account election for mutual fund or DRP stock if a taxpayer may have averaged the basis with the basis of stock held by other brokers.

How does a broker make a single-account election?

- A broker makes a single-account election simply by clearly noting it in its books and records. Additionally, a *broker must notify a taxpayer of a single-account election* through reasonable means (mailings, circulars, or email suffice). The notice must clearly identify the securities subject to the election and state that all securities will be treated as covered, regardless of date of acquisition.

If a taxpayer does not elect the average basis method for mutual fund and DRP stock, may a broker that uses the average basis method as its default method make a single-account election for that stock?

- No. *A broker only may make a single-account election following a taxpayer's average basis method election.*

Is the single-account election revocable?

- No. A broker cannot specifically revoke a single-account election.
- However, *if a taxpayer revokes an average basis method election for a particular stock, the taxpayer's revocation will void a single-account election for that stock.*
- In this case, pre-2012 stock that became a covered security as a result of the single-account election will cease to be a covered security after the election is voided.
- Conversely, if a taxpayer changes (prospectively) his or her basis determination method and ceases to use the average basis method in an account in which a single-account election was made, shares that were treated as held in a single account before the change continue to be covered securities and considered to be held in a single account.

If the average basis method is elected for mutual fund or DRP stock, which stock is sold first if some of the stock has a long-term holding period and some has a short-term holding period?

- When there is a mix of stock having long-term and short-term holding periods in an account for which the average basis method has been elected, the stock sold is determined on a *FIFO basis*.

Does the broker's default method of computing basis apply if the taxpayer fails to notify the broker of an average basis method election? Yes.

- If a taxpayer places shares of DRP or mutual fund acquired after 2011 with a broker, the basis of the shares is determined in accordance with the broker's default method, unless the taxpayer notifies the broker that the taxpayer elects another permitted method
- The taxpayer must report gain or loss using the method the taxpayer elects or, if the taxpayer fails to make an election, the broker's default method.

Example: In connection with a DRP, Taxpayer B acquires 100 shares of G Company in 2012 and 100 shares of G Company in 2013, in an account B maintains with R Broker.

- B notifies R in writing that B elects to use the average basis method to compute the basis of the shares of G Company.
- In 2014, B transfers the shares of G Company to an account with S Broker.
- B does not notify S of the basis determination method B chooses to use for the shares of G Company.
- S's default method is FIFO.
- In 2016, B instructs S to sell 150 shares of G Company.

Result: Because B does not notify S of a basis determination method for the shares of G Company, under paragraph (e)(2)(i) of this section, the basis of the 150 shares of G Company S sells for B in 2016 must be determined under S's default method, FIFO.

Use of Average Basis for Stock Purchases

Can taxpayers average the basis of different lots of identical stock purchased on the same day?

- **Yes.** Taxpayers must calculate the average of the basis of multiple lots of identical stock purchased at separate times on the same day *if the stock is purchased in a single trade order* and the broker executing the trade provides a single confirmation reporting the aggregate total cost or average cost per share. However, a taxpayer is permitted to calculate basis by actual cost per share if he or she informs the broker in writing of this intent.

Wash Sales

How is basis to be calculated on wash sales?

- Although *taxpayers must comply* with the wash sale rules of sec. 1091 for sales of securities that are *substantially similar* to securities acquired within 30 days of a sale, *brokers are only required to report wash sales when the securities have the same CUSIP number*.
- Further, brokers are only required to report wash sales when the purchase and sale transactions occur in the *same account*.

Note: Taxpayers must still comply with the wash sale rules whether the transactions occur in the same or different accounts.

Are brokers required to report wash sales for high frequency traders?

- Yes. But, the regulations do not require a broker to report wash sales for customers who have informed the broker in writing that the customer has made a valid and timely *mark-to-market accounting method election* under sec. 475(f). The exemption applies only to accounts identified by the customer as containing only securities subject to the mark-to-market election.

Short Sales

In the case of a short sale, at what point is reporting required?

- For short sales opened on or after January 1, 2011, brokers must report the sale for the *year in which the short sale is closed*. Previously, brokers reported the sale for the year in which the short sale was opened.

Example: On August 25, 2011, H opens a short sale of stock in an account with B, a broker. H closes the short sale with broker B on January 25, 2012, by purchasing stock of the same corporation in the account in which H opened the short sale and delivering the stock to satisfy H's short sale obligation.

- Because the short sale is entered into on or after January 1, 2011, the broker closing the short sale must make a return of information reporting the sale for the year in which the short sale is closed.
- Thus, B must report the information about the short sale opening and closing transactions on a single 1099B for taxable year 2012. B must report the relevant information for the sold stock, the adjusted basis of the purchased stock, and whether any gain or loss on the closing of the short sale is long-term or short-term.

Gifted/Inherited Shares

Can gifted or inherited securities be covered?

- Yes. If gifted or inherited securities were covered in the account of the donor or decedent, they remain covered upon receipt by the donee or heir.
- Covered securities transferred by gift or inheritance must be accompanied by a transfer statement that indicates that the gifted or inherited securities are covered securities.
- In the case of inherited securities, ***the transfer statement must also report the date of death and the stepped-up basis as of the date of death or as reported to the broker by the authorized representative of the estate.***
- In the case of gifted securities, the transfer statement must include the donor's adjusted basis, the donor's original acquisition date, the date of the gift, and the fair market value of the gift on that date. The transferor is only required to compute the fair market value of the securities on the date of the gift if the value is readily ascertainable at the time of the transfer.

How is a transfer of ownership to be treated by a broker, issuer, or transfer agent if the circumstances of the transfer are unclear?

- Under the regulations, if a request to transfer ownership of covered securities between different persons is silent as to the reason for the transfer, ***the transfer should be treated as a gift.***

Issuer Reporting Organizational Actions Affecting Basis

The Act provides that ***an issuer of a specified security must file a new information return*** with the IRS to describe any organizational action it takes that affects the basis of the security (such as a ***stock split or merger***) within 45 days after the date of the organizational action (unless the action takes place in December, in which case the return must be filed by January 15 of the following year).

- The return must identify the issuer and security affected by the action, provide information and a detailed description of the action, and explain the quantitative effect on the basis of the security.
- Additionally, the issuer must furnish a copy of the return to each holder of the security by January 15 of the year following the action.
- These requirements apply to corporations (except for mutual funds) for organizational actions on or after January 1, 2011, that affect the basis of the corporation's stock.
 - Mutual funds must report all organizational actions taken on or after January 1, 2012, that affect the basis of the fund's stock.

Is there an alternative to mailing the issuer statements to each holder or nominee?

- Yes. The regulations waive the requirement to file the issuer return with the IRS and furnish issuer statements to holders and nominees if the issuer:
 - 1) posts the return in a readily accessible format to a section of its *primary public website* dedicated to the sole purpose of reporting organizational actions;
 - 2) posts the return by the same due date for reporting the action to the IRS; and
 - 3) keeps the return *accessible to the public for 10 years* on its website or the primary public website of any successor organization.

Must an S corporation report organizational actions to shareholders even though it furnishes them a Schedule K-1 each year?

- No. Although S corporations are not exempt from the reporting requirements concerning organizational actions, the regulations consider an S corporation to satisfy its reporting obligations if the organizational action's effects are *reflected on a Schedule K-1* for each applicable shareholder, the K-1s are timely filed with the IRS, and copies of the K-1s are timely furnished to all applicable shareholders.

Notice 2011-21 (4/8/2011)

Tax Treatment of TIPS Issued at a Premium

Treasury Inflation-Protected Securities (TIPS) are government-issued bonds that provide a hedge against inflation. They are issued in 5-, 10-, and 30-year maturities. TIPS are issued at a fixed interest rate payable semi-annually. However, *the bond's underlying principal amount rises and falls based upon the inflation rate* (the CPI), resulting in a commensurate change in the amount of interest payable. When the bond matures, the final principal value is adjusted for inflation during the term of the bond. However, it is never less than par value.

TIPs have traditionally been *issued at a discount*, as the interest rate was set slightly below market rates. With the recent drop in interest rates, that has changed. Now the Treasury sets a *floor rate at 0.125%* which has resulted in *TIPS being issued at a premium, with negative real yields*.

This has created a tax issue, as the existing "*coupon bond method*" rules for the taxation of TIPS (contained in reg. sec. 1.1275-7 and reg. sec. 1.171-3(b)) apply to securities issued with no more than a *de minimis amount of premium*.

In this notice, the IRS announced that it will be changing the regulations to provide that taxpayers will apply the simple coupon bond method described in reg. sec. 1.1275-7(d) with respect to *TIPS issued with more than a de minimis amount of premium*, rather than the more complex "discount bond method" described in § 1.1275-7(e), that would otherwise apply.

The following example illustrates the application of the coupon bond method to TIPS issued at a premium:

Facts:

- X, a calendar year taxpayer, purchases at original issuance a 5-year TIPS.
- Principal amount is **\$100,000** and the stated interest rate is **0.125 percent**, compounded semiannually.
- The TIPS are issued in Year 1 on January 1, stated interest is payable on June 30 and December 31 of each year.
- X pays **\$102,000** for the TIPS.
- The inflation-adjusted principal amount for the first coupon in Year 1 is **\$101,225** (resulting in an interest payment of \$63.27).
- The inflation-adjusted principal amount for the second coupon in Year 1 is **\$102,500** (resulting in an interest payment of \$64.06).
- X *elects to amortize bond premium* under § 1.171-4.

Under reg. sec. 1.1275-7(d)(4), the application of the coupon bond method to the TIPS results in the following tax treatment:

- The *difference between the initial principal amount and the year-end inflation-adjusted amount* of the bond is \$2,500, which is *includible in X's income* for Year 1.
- However, because X acquired the TIPS at a premium and elected to amortize the premium, the *premium allocable to Year 1 will offset the income on the TIPS as follows*:
 - The premium allocable to the first accrual period of \$201.22 (see below) first offsets the interest payable for that period of \$63.27. The remaining \$137.95 of premium is treated as a deflation adjustment that offsets the positive inflation adjustment. (Reg. sec. 1.171-3(b)).
 - The premium allocable to the second accrual period of \$200.95 first offsets the interest payable for that period of \$64.06. The remaining \$136.89 of premium is treated as a deflation adjustment that offsets the remaining positive inflation adjustment.
- As a result, X does not include in income any of the stated interest received in Year 1 and includes in Year 1 income only **\$2,225.16** of the positive inflation adjustment for Year 1 (\$2,500 - \$137.94 - \$136.89). This will appear as **1099-OID income**—i.e., original issue discount.

The *calculation of the premium amount allocable to each interest accrual period* is done as follows:

- Under reg. sec. 1.171-3(b), the bond premium of \$2,000 is allocable to each semiannual accrual period by assuming that there will be no inflation or deflation over the term of the TIPS.
- Based on this assumption, the TIPS provide for semiannual interest payments of \$62.50 ($\$100,000 \times .125\% / 2$) and a \$100,000 payment at maturity.
- This results in a *calculated negative yield* for the securities of -0.272%, compounded semiannually.

- This yield is multiplied by the “adjusted acquisition price” at the beginning of the yield period, and that amount is subtracted from the assumed semi-annual interest amount of \$62.50 to arrive at the amount of premium allocated to that period.
- So for June 30, the allocated premium amount is $\$62.50 - (\$102,000 \times -0.002720/2) = \$62.50 + 138.72 = \$201.22$.

It’s a good thing we generally don’t have to figure these amounts out for our clients, however, here’s some disheartening language from Pub. 1212:

“Form 1099-OID. The amount shown in box 6 of the Form 1099-OID you receive for an inflation-indexed debt instrument may not be the correct amount to include in income. For example, the amount may not be correct if you bought the debt instrument other than at original issue or sold it during the year. If the amount shown in box 6 is not correct, you must figure the OID to report on your return under the following rules . . .”

Bottom Line: Make your TIPS investments in **IRAs and 401(k)s**, where you don’t have to worry about figuring out taxable income!!