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Your Money | Preparing for 2012

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At the beginning of this year, the first phase of new cost basis reporting requirements took effect, dramatically changing the way financial advisors and their clients think about cost basis.

For the first time, broker/dealers are required to report the adjusted cost basis of sold equity securities to the IRS. The new requirements are designed to help capture accurate reporting of investors' gains and losses at tax time. The changes in reporting are due to the Economic Stabilization Act of 2008 passed by the U.S. Congress.

The legislation mandates that custodians, broker/dealers, transfer agents and other reporting entities report the adjusted cost basis of sold securities, including whether the gain or loss is short-or long term to the IRS and investors on Form 1099-B.

The first phase began this year and only applied to equities, including corporate stock, ADRs, UITs, ETFs,REITS.

The second phase begins on Jan. 1, 2012 and will apply to Regulated Investment Company shares such as mutual funds.

The third phase begins a year later in 2013 and deals with fixed income, derivatives and other specified securities.

Securities bought before the beginning of the above phase dates are not covered by these new mandates

These changes have two important implications for the way cost basis has been approached in the past. First, investors need to ensure that their reports match the data sent by broker/dealers and other providers. Second, it is important to consider the tax consequences of a trade or transfer at the time of execution, because cost basis methods cannot be changed after settlement day.

The IRS now considers the reporting custodians to be the authoritative sources of cost basis information.

The new regulation states that each broker/dealer must accommodate client/investor choice. The IRS default method is First-in first-out (FIFO) for broker/dealers. If you invest directly with a mutual fund, the default method will usually be Average Cost.

Other methods include; Last-in first-out (LIFO), Highest-in first-out (HIFO), and Minimum tax. If your tax strategy utilizes a different cost basis accounting method other than your custodian's default, you and your financial advisor must indicate that at the time of the trade or transfer. Remember you have only until the settlement date to specify a particular tax lot to sell or transfer or to change the cost basis accounting method.

As a result of the new legislation, reporting custodians will be required to include additional cost basis information on the new form 1099-B. The redesigned form will show cost basis and proceeds for covered equities sold or redeemed in 2011, plus whether the gain or loss is short-or long-term.

The IRS is also redesigning schedule D and form 8949 to accommodate the required information.

These changes are going to be confusing for most investors. It is recommended that investors consult with their tax professional to determine which cost basis accounting method is best for them. In addition, investors should be aware that the default methods may be different depending where their securities are held.

The new legislation mandates a major change from the past practices of broker/dealers and other custodians, investors, and tax professionals. The best method will be determined by many factors such as your current tax bracket, and are you trying to generate tax losses or tax gains. There is not a perfect solution, which should not come as a surprise to any of us who attempt to navigate the complicated U.S. tax code

For additional go to www.irs.gov.

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