For capital gains tax, the “honor system” ends January 1

By Editor Test *Tue, Dec 28, 2010*

Before the new rule, the government didn’t have a way to verify if an investor was reporting the true gain on a sale unless there was an audit, said an Ernst & Young tax partner.

Starting January 1, 2011, the Internal Revenue Service will require brokerages to track the cost basis on equities bought after that date, and to send taxpayers and the government an annual form recording it when investors sell shares.

Brokerages already report the proceeds from sales of securities to the IRS. Next year, they’ll also have to provide information on the purchase price, known as the cost basis, of stocks.

In other words, investors will no longer be able to use the honor system when calculating their capital gains for tax purposes. Before this rule, the government didn’t have a way to verify if an investor was reporting the true gain on a sale unless there was an audit, said Greg Rosica, a tax partner at Ernst & Young who is based in Tampa, Florida.

“We expect our clients are going to get a 1099-B form in 2012 and they could have an outcome that they don’t expect,” Said Brian Keil, director of cost basis and reporting at Charles Schwab Corp.

Investors who buy shares of the same company on different dates or prices will see the biggest change, said Eric Smith, a spokesman for the IRS. They’ll need to identify which shares they’re selling before the sale settles, which typically means within three days for stocks.

The regulations take effect at later dates for other trades. Starting Jan. 1, 2012, brokers will have to record the cost basis for mutual funds and stocks held in dividend reinvestment plans, which require investors to reinvest at least 10 percent of dividends paid.

Cost-basis reporting also applies to the majority of ETFs in 2012, the IRS said.

The rules take effect for options and fixed income securities, such as bonds, acquired on or after Jan. 1, 2013, according to the IRS.

“Clients today often meet with their accountant, or when they are doing their taxes, and look backward,” said Keil of Schwab, the largest independent, publicly traded brokerage by client assets. “They select which lots they would have used with a lot of hindsight. That’s not going to be the case anymore.”

Brokerages including Schwab, Fidelity Investments and TD Ameritrade Holding Corp. will offer investors choices for reporting cost basis including using the last stock bought or highest cost, the firms said. Investors may tell the company to always sell shares minimizing gains, for example, or specify shares for a particular trade before it settles, according to the IRS.

For taxpayers who don’t choose, the brokerage must record the purchase price of the first shares bought, known as first- in-first-out or FIFO, according to the IRS. The firm may choose cost averaging as its default for mutual funds and stocks held in dividend reinvestment plans, the IRS said.

Brokerages will be required to transfer cost-basis information for stocks bought after Jan. 1, if an investor switches firms, said Gregg Murphy, senior vice president of brokerage products for Boston-based Fidelity. Firms incur a $100 penalty for sending an incorrect form to the taxpayer and a separate $100 penalty for sending an incorrect form to IRS, according to regulations.

Investors should review their tax situation before choosing a reporting method, said Sheryl Eighner, a director in the personal financial services group at PricewaterhouseCoopers LLP in Chicago. Taxpayers may want to identify certain shares if they need to offset gains with losses, for example, she said.

Depending on the amount of appreciation between the date a security was bought and sold, choosing the right reporting method could result in a smaller capital gains tax, David Sands, a tax partner at New York-based Buchbinder Tunick & Company, said.

Picking the wrong one could result in a bigger payment than necessary, he said. Gains on stocks, corporate bonds and mutual funds held at least a year generally are taxed at a maximum 15% federal rate. Short-term gains are taxed at an individual’s ordinary rate, currently as high as 35%.

Fiserv Introduces Cost-Basis Reporting Solutions

Fiserv, Inc., the provider of financial services technology solutions, today announced the launch of the first in a series of new tools to support the Cost Basis Reporting Regulation, a provision of the Emergency Economic Stabilization Act of 2008.

The law requires that, effective January 1, 2011, financial intermediaries provide to investors and the Internal Revenue Service (IRS) the adjusted cost basis for covered securities. This new regulation will provide investors the means to accurately report gains or losses on the sale of securities for their annual tax filings.

This cost basis solution from Fiserv allows for efficient daily import and calculation of data from books and records to provide adjusted cost basis information — information that can be used for reporting tax-aware strategies and for responding to tax harvest requests.

Fiserv has worked closely with its straight-through trading partners, as well as the custodians and third party vendors who provide books and records to identify changes they may or may not be making to support the regulation.

Many partners are making changes to accept “versus purchase” data in trading messages, which the allocation communication process from Fiserv already supports. In order to ensure accurate processing of specified lot relief, reconciliation is required to go down to the tax lot level.

In response to this requirement, Fiserv has introduced a full tax lot data reconciliation solution. This technology, available now, provides clients with reports and automated synchronization tools that identify and reduce differences across the entire APL platform between tax lot data, including cost basis information.

The reconciliation will enable clients to maintain tax lot consistency from one application to the next. Data synchronization reduces inconsistencies to enable accurate reconciliation and provides transparent client data that can then be reported to the IRS and the end investor.

Fiserv, a technology provider for the managed accounts industry, processes more than 3.4 million accounts on its APL platform and is the technology provider for more than 1 million UMA sleeves.