

## Cost Basis Reporting

*The Emergency Economic Stabilization Act of 2008 (the “Act”) was signed into law by President Bush on October 3, 2008, immediately following its passage by Congress. While essentially designed to address the current crisis in the financial system and securities markets, Section 403 of the Act amends Section 6045 of the Internal Revenue Code of 1986, as amended (the “Code”), to require brokers, shareholder services agents and mutual funds to comply with reporting requirements regarding an investor’s cost basis in securities transactions.*

Code Section 6045 sets forth information reporting rules that apply to “broker” transactions. Under regulations of the Internal Revenue Service, the term “broker” is broadly defined generally to include, among other things, a dealer, any other person who for consideration “regularly acts as a middleman with respect to property or services”, and a “depository trust or other person that regularly acts as an escrow agent in corporate acquisitions, if the nature of the activities of the agent is such that the agent ordinarily would know the gross proceeds from sales.” Thus, the term “broker” covers not only broker/dealers, but shareholder service agents such as tender offer depositaries, dividend reinvestment and stock purchase plan agents, exchange agents and the like as well. In this Advisory, when we use the term “broker” we mean to cover all of these entities.

Historically, Code Section 6045 generally required a broker, after a sale of securities, to file an information return setting forth the name, address and taxpayer identification number of the customer, the CUSIP number of the securities sold and the gross proceeds realized in connection with the transaction. The Act expands these obligations by mandating brokers also to keep track of and report the customer’s adjusted basis in “covered securities”, using either the first-in, first-out method or the average cost method, and whether any gain or loss is short-term or long-term. Although there are exceptions, a “covered security” is any security (i) “acquired through a transaction in the account in which such security is held” or (ii) “transferred to such account from an account in which such security was a covered security”. The new law contains provisions addressing short sales, exercises of options and how the adjusted basis is determined (including rules specifically applicable to stock acquired pursuant to a dividend reinvestment plan), and a requirement to provide a written statement regarding the matters set forth in the Act in connection with a transfer of a covered security to a broker.

The statute at this point leaves open many questions. We expect the Internal Revenue Service to issue regulations to clarify some of these issues over the coming months.

The effective date of the new reporting requirements depends on the nature of the covered securities. Reporting for stock in a corporation must generally begin with stock acquired after January 1, 2011. The requirements will extend to shares in mutual funds pur-

chased after January 1, 2012, and to debt instruments, options and other securities purchased after January 1, 2013.

While some tax experts feel that cost basis reporting will be helpful to investors, who might otherwise buy stock and reinvest the dividends without ever being aware of the cost basis, some commentators believe that the motive behind the law is less about assisting individual investors and more about generating revenue. When studying math errors involving cost basis, the Internal Revenue Service found that the majority of the errors worked in the individual taxpayer's favor. In fact, the Internal Revenue Service estimates that the new reporting requirement will generate \$6.7 billion for the U.S. Government over the course of a decade.

Although brokers have expressed concern regarding the implementation of the new requirements, the Securities Industry and Financial Markets Association, among others, believes that the Act allows for adequate time to address these concerns before compliance is mandatory. For example, instead of the previous January 31st deadline for sending out tax documentation, brokers will have until February 15th. However, the new obligations may well require massive system upgrades that will involve a significant investment of time and money to prepare for the initial January 1, 2011 deadline. Thus, it is not too soon to begin to plan towards meeting these requirements.

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