Recent changes in tax reporting

by Stephen Scott, CFP®

Trying to make sense of the new tax reporting laws for your investments can seem daunting. According to Deanna Flores, Principal at KMPG, LLC, recent changes to the year-end tax statements investors receive is “one of the largest changes in tax reporting for investors in over 20 years.” The purpose of these changes in reporting requirements is to help taxpayers report accurate and timely information on their tax returns.

Prior to 2011, if a security was sold in a taxable account, the broker would send the investor an annual 1099 report which contained a section titled “1099-B.” The 1099-B would include a description of the security, the symbol, the quantity sold, the date of sale, and the gross proceeds of the transaction. It was the responsibility of the investor to provide the cost basis or amount paid for each security sold on Schedule D-1 of the investor’s tax return. The broker was not required to send the IRS any information related to the cost of the securities that were sold.

The annual tax report investors now receive will show the cost basis of the securities sold and whether the gain or loss is short or long term. Starting in 2011, the Emergency Economic Stabilization Act caused a few changes in the 1099-B. One of the key provisions of the law is that brokers like Charles Schwab, Fidelity, Vanguard, etc. must now report cost basis information on securities sold in taxable accounts to both investors and to the IRS. Since this is an enormous change for the brokers, the IRS is phasing in the reporting requirements. Individual stocks purchased on (or after) 1/1/2011 will be considered “covered securities,” meaning they will fall under the new reporting requirements. Mutual funds and most Exchange Traded Funds purchased this year (2012) will become “covered,” and Fixed Income and Options will be covered in 2014. This law only applies to taxable accounts and will have no impact on IRAs, Roth IRAs, 401ks, or 403b accounts.

What should investors be doing to make sure everything goes smoothly when it comes to tax reporting?

A much larger number of taxpayers will be impacted by the new law because mutual funds will be covered in 2012. It is important that you are prepared. Be sure to review the cost basis your broker has for your investments to make sure there are no unnecessary surprises when it comes time to file your taxes.

First, verify that your broker has the correct cost basis for all of the holdings in your taxable accounts. Even if an uncovered security is sold and the basis is not reported to the IRS, it is a good idea for your broker to have accurate information. Cost basis information can be viewed online or in your monthly statements.

Second, be sure that your broker is using your desired cost basis matching method for your security sales or transfers, as there are many methods from which to choose. This is important because if the method is incorrect, you could end up paying taxes that could have been avoided; an example of which is a gift of appreciated shares of an investment to charity. When gifting shares, you would prefer to give the lowest cost shares, leaving the higher cost shares in your account. Unless you have specifically instructed your broker which tax lot of shares to transfer, the broker is more likely to use the default cost basis matching method which may be different than what you wanted for the gift.

What if you notice incorrect information has been reported on the 1099-B?

If you happen to notice there is an incorrect cost basis figure on your reported 1099-B, contact your broker or advisor immediately. The general rule is that you have until the settlement date of the security sale to adjust the cost basis (1 day for mutual funds; 3 days for equities) to provide your broker with the correct information. If the trade has already settled, you may not be able to change the basis reported to the IRS on the 1099-B. In this case, form 8949 is used to correct any reporting errors on the 1099-B.

Are there any other resources that may help investors understand the cost basis reporting changes?

The best place to start is with your broker’s website, which is likely to have a Cost Basis Frequently Asked Questions (FAQs) page about the new requirements.

You can also go directly to the IRS website: http://www.irs.gov/Tax-Professionals/Cost-Basis-Reporting-Overview-and-FAQs, which contains information and a detailed FAQ section. Your financial advisor or CPA should also be able to answer any questions you have about the new regulations. By using all the resources available, you will be able to navigate the new tax reporting laws with ease.

Stephen Scott, CFP®

Stephen (Scotty) Scott, CFP® graduated from The University of North Carolina at Greensboro in 2002 with a BS in Business Administration and from Quincy University in 2004 with a Masters In Business Administration. Scotty earned the CFP® designation in 2007 and began working for Abacus Planning Group in 2011. Scotty is a member of the Investment Team and works closely with the other advisors to assist in the investment management process. Abacus Planning Group, Inc., located at 2500 Devine Street in Columbia, SC, is a fee-only financial planning and investment counsel firm managing over $620,000,000 in assets primarily for individuals.