Tax Planning for Securities Transactions

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Taxpayer Action *Required* at time of Placing the Sale Order

New regulations now require brokers and custodians to report specific lots sold, cost basis, amount of gain/loss, the dates of the acquisition and sale, and the character of the gain/loss (short-term/long-term) at the time of the settlement of the transaction. All of this information will be reported directly to the IRS. Unfortunately, there will not be an opportunity to resolve any cost basis issues after settlement. Taxpayers and their advisors must be proactive in making decisions regarding accounting methods for the securities.

Background

The Emergency Economic Stabilization Act of 2008 (EESA), requires that brokers track and report to the IRS cost basis on securities transactions. This was passed to be more certain that taxpayers were properly reporting investment gains and losses. The rules became effective for all purchases beginning in 2011 for equities and 2012 for mutual funds, and will be effective in 2013 for most other securities.

The most significant part of the changes is that the decision about which lots are to be sold must be made by the settlement of the transaction. Tax laws have technically always required this determination; however, many taxpayers waited until year-end tax planning when they had an idea about their tax situation and then updated their cost basis records. Since the cost basis will now be reported on the Form 1099 provided by the brokerage firm, this practice will no longer be available.

Method of Accounting

If no method of accounting is chosen, the law specifies a default method which is average cost for mutual funds and first-in, first-out (FIFO) for all other securities. At the time of any sale, a taxpayer can adjust the method used for that transaction or specify which lots will be sold. Again, this must be done by the settlement date or the default method will apply.

Under the new regulations, if a taxpayer does not want to use the default methods, they must inform their broker or custodian of what method they prefer to be used and the broker or custodian will use that method for any future sale. *IRS approval is not needed for this change of accounting method; a taxpayer only needs to inform their broker or custodian.* There is one restriction that any mutual fund shares partially sold under average cost must use average cost for remaining shares.

Although every taxpayer's situation is different, many taxpayers will favor one of two methods of accounting:

Lowest Cost: This method recognizes sales of securities with the lowest cost first, therefore recognizing the biggest gains first, while saving losses. This maximizes the recognition of income. This method may be advantageous while tax rates are still reduced under the "Bush tax cuts." Generally speaking, generating additional income is unfavorable; however with rising tax rates, capital gain rates stated to increase significantly, and the additional 3.8% Medicare Tax on investment income for higher income taxpayers, accelerating income while taxes are low may be an advantageous choice.

Highest Cost: This method recognizes sales of securities with the highest cost first, therefore recognizing the biggest losses first, while saving gains. This minimizes taxable income and has always been a favored approach.

The default methods may not always be effective in controlling taxable income. While FIFO may seem to maximize taxable income, with the volatility of the market, older shares do not always have the lowest cost. Unfortunately using FIFO or average cost may not have the desired tax effects either.

Given that taxpayers may not wish to utilize the default methods or methods listed previously, there are many other methods available, depending on the broker or custodian. It is important to understand which methods your broker or custodian offers and consider the tax effects along with your specific tax situation so that you can make an appropriate decision.

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Key Points to Remember:

- Cost basis is tracked at the time of the settlement of the transaction and will be reported to the IRS.
- The flexibility to change methods will facilitate maximum tax management – but proactive planning will be required
- Cost basis cannot be changed after the settlement date of a transaction.
- The default method of accounting may not be optimal for every taxpayer.
- Be sure your broker or custodian is using the method you desire on your securities.

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