Cost Basis: The Effects

Purpose:

This document has been created for issuers as an informational resource detailing both Colonial Stock Transfer (CST) and the issuer’s role in maintaining cost basis for shareholders under the new IRS cost basis regulations. CST has been updating its programs and systems, procedures, and reporting obligations to prepare for this unparalleled change. You as the Issuer will have changes to make as well. Issuers should consult with your tax accountants to establish and familiarize yourselves with your full responsibilities.

Rule Overview:

In October 2008 the Emergency Economic Stabilization Act was signed into law. As part of that Act, the IRS requires all equity securities and units of investment trusts to maintain, pass-through and report all cost bases on all transactions, beginning January 1, 2011 and including all investments made thereafter. This regulation will provide a greater transparency on capital gains tax and investment activity for the IRS.

Unfortunately, penalties may be assessed for non-compliance in reporting incorrect or no information to the IRS. These fines are based on each tax-lot: $100 for filing an incorrect 1099B and $100 for filing an incorrect report with the IRS. Transfer statement penalties may also apply for not passing or receiving cost basis correctly. These fines currently range from $15 and $50 per transfer statement with aggregate fines of between $75,000 and $250,000. Fines may be lower for smaller companies, but substantial nonetheless. The maximum fines may reach $3 million.

The final rule can be found at http://colonialstock.com/forms/costbasisfinalregs.pdf.

Table of Contents:

Part I: Basic Transfer Requirements
Definitions......................................................................................................................... 2
Individual Transfers........................................................................................................ 3
Entity Requirements........................................................................................................ 3
Lost Certificates............................................................................................................... 4

Part II: Issuer Responsibilities
Stock Plan Issuances..................................................................................................... 4
Corporate Actions.......................................................................................................... 4
Fair Market Value........................................................................................................... 5
Part I: Basic Transfer Requirements

Definitions:

Cost Basis Tax-Lots

Cost basis is the total cost of an asset or security, which is usually equal to the purchase price of the security plus commissions and other expenses. The final cost basis regulations require cost basis to be tracked through “tax-lot” positions, which are comprised of the original cost basis and acquisition dates. Multiple “tax-lots” may exist in a shareholder position, resulting in multiple acquisition dates. The acquisition date is the date the security was purchased, not the issue date listed on the stock certificate or book-entry shares. Transfer agents are now required to maintain the purchase dates as well as the cost basis of each lot, requiring significant revisions and enhancements to the current record keeping layouts. Shareholders may choose how to calculate their cost basis, however if the shareholder does not specify, CST will use the FIFO method (first in, first out). We must be notified of the calculation method by the transfer date.

Non-Covered Shares

Shares acquired before January 1, 2011 are defined as “non-covered” shares and are not required to be recorded because they are unavailable, and therefore exempt from being reported to the IRS. Also, if a presenter of a transfer does not provide cost basis on the shares being transferred, the shares will be listed as “non-covered”, in which, we are required to make one request for the cost basis.

Transfer Statements

Transfer agents are required to pass and receive cost basis through transfer statements to and from brokers and shareholders as applicable. The broker custodians, issuers, or transfer agents must generate a transfer statement within 15 days of the date of transfer and submit it to the recipient of such shares. Statements must be sent on all transfers, including non-covered shares resulting from transactions before January 1, 2011 or if the transfer agent isn’t required to generate a 1099B. If a transfer agent or broker does not receive a transfer statement with a transfer, then they must make one follow-up request for the statement. If they do not receive it, they can then code the shares as non-covered. Each transfer statement must contain the following information:

- The statement, transfer, and settlement dates;
- The cusip number;
- The shareholder’s name address, phone number, Tax ID/SSN, and account number;
- The name, address and telephone number of the sender and receiver of the cost basis;
- The adjusted cost basis of each tax-lot with the original acquisition dates affected by wash sales and a separate date short-term vs long-term gain comparisons;
- And if the shares were acquired through an inheritance or as a gift.

The Depository Trust and Clearing Corporation has designed new software to accommodate all pass-through information through their CBRS program. As your transfer agent, Colonial will have access to this program and has been working expeditiously to expand and update all
software and systems to accommodate these changes. Please note that our transfer prices will go up in January to help offset some of the costs incurred.

**Corrected Transfer Statements**

Corrected transfer statements may need to be sent if there are any errors in the cost basis reported at the time of transfer. These corrected statements are required to be sent within 15 days from the date that the error was reported. Transfer agents are only required to send statements on transfers completed within the last 18 months, or in the case of 1099B sales, within the last 36 months. The recipient of the shares cannot pay for this information unless they are also the presenter of the transfer request. Because of this, the issuer may be billed for additional costs incurred.

**Individual Transfers:**

After the effective date of the regulation, presenters of transfers will be required to report the following on each tax-lot: the cost basis, acquisition date, and whether the shares are gifted or inherited.

In the case where the shares are gifted, then CST will require the date of the gift, the fair market value ("FMV"- discussed in more detail later) as of the gift date, the donor’s acquired date, and the donor’s cost basis. This information is required for the determination of the correct cost basis allowed when the recipient sells their shares. CST must also transmit the tax lots in transfer statement form. If the presenter provides information about the gift and value, then CST may accept this and record it.

**Entity Requirements:**

**Estates**

If a transfer is due to a death, then the transferred shares are treated as inherited. As long as the transfer agent received the valuation date and price with the transfer, then the basis is recorded along with the date of the death as the acquisition date. The tax lots are then recorded as inherited lots and are then noted on the transfer statements. The “inherited” indicator must carry forward to all future transfers or gifts because the shares are classified as “long term”. If an estate valuation is received after the transfer, then the transfer agent must send a corrected statement to the receiving broker. When the cost basis information is not provided, then the transfer agent will record the date of death as the acquisition date and FMV on that same date as the cost basis. When the FMV is not readily accessible, then the shares are non-covered.

**Joint Tenants**

If a transfer of shares is from Joint tenancy to the tenants as individuals, then the transfer agent must either:

1. Follow the transfer instructions, applying specific cost basis lots to each individual account as instructed, or
2. Absent cost basis instructions, transfer the shares as directed and, using the original lots, create cost basis lots in each new account in proportion to their share transfer allotment.

**Lost Certificates:**

Whenever certificates are lost and replaced by the transfer agent, then the cost basis tax lots and acquisition dates are carried forward to the new certificate/s.

**Part II: Issuer Responsibilities**

Issuers should consult with their tax accountants on the full scope of their responsibilities. These cost basis regulations are still being reviewed by industry committees and tax experts. Please do not consider this information as definitive, although as changes develop, we will endeavor to keep our clients apprised of them to the extent that the changes affect Issuers or their shareholders. One fact that is clear is that these regulations are requiring more programming and operation modifications than have ever been experienced in the past 30+ years in the transfer industry.

**Corporate Actions:**

Issuers will be required to file an Issuer return with the IRS for any corporate action affecting the cost basis of its securities, i.e., stock dividends, stock splits, return of capital, spin-offs, and mergers. The return must include the type of the action, effective date, the quantitative effect and calculation description of the corporate action, the applicable IRS code, valuations, the reportable taxable year, and any resulting losses. This return is required to be filed within 45 days of the action, or by January 15th of the following year, whichever is sooner. This filing may be waived if the Issuer posts the information required for 10 years in a readily accessible format in an area on their website dedicated to this purpose, using the same due dates.

Issuers are required to furnish a statement to all shareholders describing the corporate action and the effects of the action on the cost basis. Colonial will use the statements provided by the Issuer to adjust the basis recorded on the shareholder records for any covered shares.

Failure to comply with these statement rules may result in the IRS assessing significant penalties on Issuers.

**Stock Plan Issuances:**

Many issuers have various stock option plans or other employees stock compensation programs. When stock is issued through a program from which a cost basis is available, such as a stock option program, issuers or their plan administrators will be required to provide Colonial and/or their broker with cost basis for the issuance. The basis may also be provided to the employee. Restricted stock is exempt from this requirement as the IRS defines a covered security as one received for cash. Therefore, employee grants would be considered non-covered.
The Issuer’s website should include information as to the cost basis for any employee plan, option or similar issuances, and provide the daily Fair Market Value when their securities are not actively traded on an exchange.

**FMV or Fair Market Value:**

Fair market value is required when determining the value of securities transferred between individuals and categorized as gifts. Issuers whose securities are not listed are also required to provide the Fair Market Value for their securities.

Unless specific information is provided by the presenter of transfer, the transfer is re-coded as a gift. When the transfer is deemed a gift, the transfer agent must record the FMV of the security as of the date of the gift.

**Determining FMV**

For listed securities, Colonial will go to the listing market and follow the rules noted below to calculate the FMV and record it with the transfer. However, for non-listed securities or securities which trade infrequently, Issuers will be required to provide Colonial with the FMV as transfers occur.

Issuers can use the IRS rules to establish when and how FMV is to be determined for their security. When there isn’t viable trading data available, issuers may have to determine the net worth of the company as outlined in the last section of this article. Where no public market exists for a security, issuers will be asked to provide the FMV whenever Colonial receives a transfer that has been identified or deemed to be a gift or inheritance. Colonial will scan and retain as part of the transfer agent’s required records for the transaction.

We have attached an excerpt from the IRS rule explaining how Fair Market Value is determined.

**Sec. 25.2512-2 Stocks and bonds**

**Excerpt as relating to stocks taken from rule:**

(a) *In general.* The value of stocks and bonds is the fair market value per share or bond on the date of the gift.

(b) *Based on selling prices.* (1) In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond. If there were no sales on the date of the gift but there were sales on dates within a reasonable period both before and after the date of the gift, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the date of the gift. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the date of the gift. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available
listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the donor should be careful to consult accurate records to obtain values as of the date of the gift. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from the officers of the issuing companies, copies of letters furnishing such quotations or evidence of sale should be attached to the return.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). Assume that sales of stock nearest the date of the gift (Friday, June 15) occurred two trading days before (Wednesday, June 13) and three trading days after (Wednesday, June 20) and on these days the mean sale prices per share were $10 and $15, respectively. The price of $12 is taken as representing the fair market value of a share of stock as of the date of the gift:

\[ p = \frac{(3 \times 10) + (2 \times 15)}{5} \]

Example (2). Assume the same facts as in example 1 except that the mean sale prices per share on June 13 and June 20 were $15 and $10 respectively. The price of $13 is taken as representing the fair market value of a share of stock as of the date of the gift:

\[ p = \frac{(3 \times 15) + (2 \times 10)}{5} \]

Based on selling prices

If there is a market for stock, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share.

If there were no sales on the date of the gift, but there were sales on dates within a reasonable period, both before and after the date of the gift, then FMV is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and after the gift.

If stock is listed on more than one exchange, the records of the exchange where the stock is principally traded should be used if such records are available in a generally available publication, or if not so available, and stock is listed on a composite of exchanges the records of such combined exchanges should be engaged.

If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from the officers of the issuing companies, copies of letters and/or emails are retained by transfer agent.

Based on Bid and Ask prices

When actual sales prices are not available within a reasonable amount of time before and after the gift date, then the mean between the highest and lowest available sales prices or bid and ask prices may be taken as the value.
Securities with no sales, AND no bid/ask in reasonable period before and after the gift, AND bid/ask prices are unreasonable

When selling prices or bid and ask prices do not represent fair market value. In cases in which it is established that the value per share of any security determined on the basis of the selling or bid and asked prices, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value. Where sales at or near the date of the gift are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of securities made the subject of each separate gift in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the donor can show that the block of stock to be valued, with reference to each separate gift, is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued should be submitted with the return. If the block of the stock to be valued represents a controlling interest the priced at which other lots change hands may have little relation to its true value.

When selling prices or bid and ask prices are unavailable

If actual sale prices and bona fide bid and ask prices are lacking, then the FMV is to be determined by taking the following factors into consideration:
The Company’s net worth, prospective earning power, and dividend-paying capacity, and other relevant factors.