

## **COST BASIS CHANGES - MUCH ADO ABOUT NOTHING FOR STOCK PLAN PROFESSIONALS?**

The title of this piece is a bit glib, because these recently released regulations are going to be extremely painful and extraordinarily costly for your broker, your transfer agent, and/or your outsourcing provider. However, most stock plan professionals are likely to be impacted only minimally.

I can just imagine the hundreds of brokerage-house and transfer agent programmers burning the midnight oil and frantically writing millions of lines of code to deal with these changes and the literally massive system enhancements that will be needed. And all by 1/1/11 when the final regulations were only released in mid-October of 2010!

For many of our readers, however, the only real impact may be the cost of these enhancements that many providers are passing on to their clients. Painful and annoying, but not necessarily impactful to your day-to-day life and not requiring the stock plan team to take steps or change processes.

Some of you may have to give your broker or provider a few new pieces of information (e.g. is your ESPP 423-qualified; how you calculate ordinary income on NQ exercises), but will have little else to worry about.

However, there *are* those among you that these new regulations will impact a bit more and, for some of you there are steps you *should* take, or at least consider taking. You are more likely to be impacted, if:

- You issue ISOs and/or 423-qualified ESPP plan shares,
- You use brokers unaffiliated with your software or provider system and
- Your provider(s) are planning to report *price* as the cost basis for stock plan transactions (which is allowed under the final regulations) as opposed to the real cost basis.<sup>1</sup>

First we'll provide a little background on the new regulations, then we'll discuss the different types of companies this is likely to impact for stock plans and why.

**Note:** This article is specifically targeted to cover the parts of the new regulation that we think most likely to impact stock plan professionals. A discussion of the entirety of the regulations is outside the scope of this article.

### **Background**

#### **What is cost basis?**

Cost basis is used to calculate taxes on sales of securities. It is the expense incurred with the purchase of an equity asset. This includes the price paid for the stock plus fees or commissions.

For securities acquired via a stock plan transaction (option exercise, RSU release, etc.), however, cost basis is not simply the price paid, but the amount on which taxes have already been paid (i.e. the "ordinary income" of the transaction in which the shares were acquired). For example, when a non-qualified option is exercised or an RSU vests and shares are delivered, the issuing company withholds taxes on the transaction gain using market value on the day of the transaction less any price paid<sup>2</sup>. Therefore that market value becomes the cost basis for those shares. Taxes have been paid on the income up to that market value. When shares are sold, gain is computed based on the difference between the transaction market value and the sales price. This is the capital gain amount, either short-term or long-term depending on how long the shares have been held before they are sold.

Cost basis for shares acquired via a stock plan transaction varies based on the type of instrument. The chart below summarizes the treatment based on instrument type:

Type	Cost Basis
ISO Options	<b>Qualifying Disposition:</b> Price <b>Disqualifying Disposition:</b> <b>Gain:</b> min(MV at Exercise, Sales Price) <b>Loss:</b> Exercise Price (if exercise price > sales price)
NQ Options	Market Value at Exercise
Stock-Settled Stock Appreciation Rights	Market Value at Exercise
Restricted Stock Awards	Market Value at Vest
Restricted Stock Units	Market Value at Release (often Vest)
423 ESPP	<b>Qualifying Disposition:</b> Price Paid + Ordinary Income <b>Disqualifying Disposition:</b> Market Value at Purchase
Non-Qualified ESPP	Market Value at Purchase

### Why all the fuss? What is changing?

Brokers and Transfer Agents have never been required to track or report this cost basis information to their customers. When the shares are sold, it has been the seller's responsibility to backtrack through (sometimes years of) statements to excavate the price that was originally paid for the stock, to report that on the IRS' Schedule D and calculate the gain (or loss) on the transaction.

Starting on January 1, 2011, however, the brokers and transfer agents (recordkeepers) *will* begin to be responsible for tracking and reporting cost basis. When shares are sold the recordkeepers will have to report the cost basis on the revamped 1099-B ([draft shown here](#)). When shares are transferred, the institutions involved in the transfer must exchange the cost basis information.

For stock plans, the regulations are, in my humble opinion, a little, well...odd. They do *not* require the recordkeepers, at least initially<sup>3</sup>, to report the cost basis shown in the table above. Instead, they are requiring the tracking and reporting of the price *paid* which, for most stock

plan transactions, is not the correct amount. Using this amount when completing a Schedule D is likely to result in participants paying too much tax - paying tax twice on the same gain - once at acquisition of the shares and again at the disposition. And any instruments types that do not involve the payment of a "price", such as restricted stock awards and units, and even stock-settled SARs, are "non-covered" securities for whom reporting is not required.

If your employees, by some miracle, do get the cost basis right by not using the amount shown on the 1099-B, this may result in non-compliance notices from the IRS to your stock plan participants, since the amounts reported will not match the 1099-B sent to the IRS.

**But don't panic, good news!** We've been reaching out to many of the stock plan providers, brokers, and vendors in our industry and those we've spoken to are all planning to report the correct cost basis, as shown in the table above, not just the price paid. Phew. So this means that the 1099-Bs sent to your participants will be correct and we can all stop worrying, right?

### **If that's true, why are the companies mentioned above still impacted?**

We'll take one category at a time and explain:

#### **ISOs and 423-Qualified ESPPs**

As I'm sure you're already aware, the taxation for ISOs and 423 ESPP shares is not triggered at the time of exercise or purchase. Tax liability is triggered by the disposition (typically sale) of the shares. Therefore, at the time the shares are acquired, the broker may not know the cost basis. When the shares are sold, the broker may be able to calculate, and thereafter report, the correct cost basis depending on the type of disposition (qualifying or disqualifying).

However, if you participant exercises or purchases and holds the shares, then later chooses to transfer shares out of the designated brokerage account, the designated broker will not have the cost basis information to send and therefore the receiving broker will not be able to store and track the information and, ultimately, when the shares are later sold, the cost basis will not be available or reported.

Again, some mitigating circumstances may apply: most ISO exercises are still same-day sales, in which case the shares won't be held and therefore won't be transferred. ESPPs are likely to be a bit more of an issue since employees tend to hold these shares longer.

We think a little employee education is called for to explain the advantages of keeping their shares with the designated broker and the ramifications of not doing so.

#### **Brokers unaffiliated with their software or provider system**

Many companies now outsource their stock plan administration to a third-party provider who either is a brokerage firm or has an affiliation with a brokerage firm or transfer agent. If your

company has chosen this approach, your provider should have (nearly) all the necessary information to calculate, track, and report cost basis to your employees correctly. Talk to your broker to confirm that they are planning to report the real cost basis, not merely the price paid for the shares as the regulations allow.

Other companies use a system or software and an unaffiliated brokerage or transfer agent (Software A and Broker Z). When shares are delivered to the brokerage, these companies are using some sort of statement, report, fax or spreadsheet to communicate with their broker as to how to allocate the shares being transferred from the transfer agent among the participant brokerage accounts. Many companies use the same DWAC instructions that they send to their Transfer Agent to initiate the transfer and simply send a copy to the broker. These statements should be updated to include the correct cost basis for the various types of instruments.

Though the regulations include exhaustive details about the format of these "Transfer Statements" they also say that "any format" that is agreed upon by the furnisher of the transfer statement and the recipient broker will suffice. So the guidelines for the format of the statement really need not concern you as long as your broker agrees to the format you employ.

On a side note, I'd like to encourage all of you to start looking into ways to automate the creation of this statement (custom reports, exports, etc.). Not only will automation save you manual effort (and therefore time and money), but it will significantly reduce the chance of an error in the creation of these statements. If the data can go directly from the stock plan database to the broker with little or no manual intervention, the risk of error is minimal and your SOX audits may take a little less time to boot.

### **Brokers Planning to Follow the Letter of the Law**

As discussed above, the new regulations:

1. Do *not* immediately require the broker to track and report the *correct cost basis*, only the *price paid* for the shares
2. Do not apply to shares for which no price was paid, such as RSAs, RSUs, and stock-settled stock appreciation rights

Many brokers are planning to go above and beyond and report the cost basis of stock plan shares *correctly on the new 1099-Bs*. But what if *your* broker isn't? If you are concerned about your participants reporting the correct cost basis (and therefore paying the correct amount of tax) you may want to consider an employee communication campaign sometime next year, before the "incorrect" 1099-Bs start arriving in mailboxes across the country. Further, I'd suggest you kick off this campaign in the later part of summer of 2011, after your quarter or year close nightmare has subsided. As the calendar/tax year draws to a close you have enough other responsibilities to keep you busy and once tax season hits, you'll be busy answering employee questions and request for duplicate confirms, the last thing you need is an education campaign at the same time.

Some practical suggestions on ways to educate your employees (on this and all other stock plan topics):

- **Get management onboard**  
Often, if you can demonstrate that your communication plans really are a benefit to your employees and that you can accomplish them with little-to-no out-of-pocket expense, they will readily get behind your efforts and back you up when stretching outside of your comfort zone.
- **Communicate early, communicate often**  
Here you walk a fine line to avoid communicating too often and having employees tune out instead of paying attention to your message. With a little effort and keeping an ear out for employee grumbles, you can make your point and educate your employees despite their best intentions to avoid it.
- **Keep communications concise**  
Really. Truly. Do your best to keep key points in an email "above the fold" (don't make your employees scroll down to get to the meat of the communication - many won't). Yes, it can be a challenge after legal has put in their comments and caveats, but do your best to arrive at a compromise.
- **Try new forms of communication to get their attention**  
Do a quick webcast (under 5 minutes long) on the basics of the how they will be impacted, and record it so they can listen at a convenient time. Try a broadcast message on your voicemail system. Create a humorous cartoon video on the site [www.xtranormal.com](http://www.xtranormal.com) (see this example of an [equity-comp-themed cartoon video](#)). Trying a new, lighter approach is likely to get more employees paying attention and they may actually retain some of the information you provide.

In closing, despite the title of this article, please don't take these regulations too lightly. For your providers, these really are fundamental, sweeping changes to systems that are already groaning under the weight of their own complexities. You should see the pages and pages of examples of cost basis calculations sent to me by one provider (wash sale transaction calculations are particularly baffling). And there are other aspects that will impact your company such as the Corporate Action Reporting, but most of it, thankfully, should not impact the stock plan group.

Questions? Comments? Please feel free to contact me at [edodge@sos-team.com](mailto:edodge@sos-team.com).

<sup>1</sup>This should be a minority however, as we'll discuss later.

<sup>2</sup>In same-day sales of NQ options, the company can choose to calculate the gain based on the market value of the stock or the actual sales price of the stock.

<sup>3</sup>It is unclear from the wording of the final regulation whether the recordkeepers are required to begin reporting the "correct" cost basis in 2013 or if the ability to report price paid is a permanent exception.

**Special Thanks:** Many thanks to Andrew Schwartz, of [BNY Mellon Shareowner Services](#), for teaching me everything I know about cost basis reporting (and therefore providing nearly ALL of the content for this article), while still maintaining a sense of humor.

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