



## **Cost Basis Confusion:**

# **What Do the New Regulations Mean for Stock Plan Professionals?**

**Elizabeth Dodge, CEP**  
**Stock & Option Solutions, Inc.**  
**Andrew Schwartz, CEP, CPA**  
**BNY Mellon Shareowner Services**



## **Materials**

<http://www.sos-team.com/PDFS/cost.pdf>



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## Agenda

- The New Regulations
- What is Cost Basis?
  - Cost basis for stock plan shares
- How do the New Regulations Impact Stock Plans?
- Practical Steps

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## Legislative History

- IRS study
  - IRS believes capital gains revenues mis- or under-reported
- The Emergency Economic Stabilization Act (ESSA) of 2008 became law on October 3, 2008
- Proposed Regulations - December 2009
- Final Regulations – October 2010
- <http://www.gpo.gov/fdsys/pkg/FR-2010-10-18/pdf/2010-25504.pdf>
- Effective dates
  - January 1, 2011: stock/equities
  - January 1, 2012: mutual funds and Dividend Reinvestment Plans (DRIPs)
  - January 1, 2013: other securities (debt securities and options)

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## Requirements of New/Revised Law

- Basis Reporting (6045)
- Transfer Statements (6045A)
  - Brokers & TA's have to pass basis info between
- Corporate Action Reporting (6045B)
  - Post announcement
    - Website
    - Central location

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## What Does it Mean for the Securities Industry?

- Massive investment
- System changes, delays other development
- Communication program
- Very short timeframe
- Third-party vendors

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## Cost Basis Post-2010

- Broker (seller) for reporting cost basis data to participant and to IRS
- Participant responsible for reporting correct basis to IRS on Schedule D
  - (Even if incorrect on 1099-B)
- Must track “covered” and “non-covered” transactions by lot and report sales
  - A covered equity security is a purchase of stock **for cash** after January 1, 2011
- 1099-B to include cost basis information and classify short-term or long-term capital gain/loss based on specified lots

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## DRAFT of New 1099-B

7979  VOID  CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. 1a Date of sale or exchange OMB No. 1545-0715  
 1b Date of acquisition **2011**

2 Sales price of stocks, bonds, etc. Reported to IRS  sales price  sales price less commissions and option premiums  
 \$

PAYER'S federal identification number RECIPIENT'S identification number 3 Cost or other basis 4 Federal income tax withheld  
 \$ \$

RECIPIENT'S name 5 Wash sale loss disallowed 6 Check if a noncovered security

Street address (including apt. no.) 7 Reported gain or loss 8 Type of gain or loss  
 \$ Short-term  Long-term

City, state, and ZIP code 9 Description

CUSIP number 10 Profit or (loss) realized in 2011 on closed contracts 11 Unrealized profit or (loss) on open contracts—12/31/2010 14 Bartering  
 \$ \$ \$

Account number (see instructions) 2nd TIN not  12 Unrealized profit or (loss) on open contracts—12/31/2011 13 Aggregate profit or (loss) on contracts 15 Check if loss not allowed based on amount in box 2  
 \$ \$ \$

Form 1099-B Cat. No. 14411V Department of the Treasury - Internal Revenue Service  
**Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page**

Copy A For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2011 General Instructions for Certain Information Returns.

## What is Cost Basis?

- Basic Definition:
  - Buyers of securities - pay something for securities
    - May also pay fees
  - Fees + costs = basis
    - Starting point
    - When security is sold, compared to the proceeds to determine gain or loss
- For Stock Plan Securities: “real cost basis” also includes “what you’ve paid taxes on”
  - (AKA “Ordinary Income” or “Compensation Income”)
  - Included as W-2 income and/or taxes withheld

## What is Cost Basis?

- Example:
  - Purchase 100 shares of ABC at \$34 per share on Nov 18, 2010
    - Pay \$25 in fees to purchase shares
  - Cost basis =  $(100 * \$34) = \$3,400 + \$25 = \$3,425$
- Currently, transfer agents and brokers not obligated to:
  - Retain cost basis information
  - Retain purchase date
  - Make adjustments due to corporate actions (stock splits)
  - Transfer information to a successor broker
  - Report basis on Form 1099-B when shares are sold

**Starting 2011, this will change...**

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## WHY SHOULD YOU CARE?



## Cost Basis for Stock Plan Shares

| Type          | Cost Basis  |
|---------------|---|
| ISOs          | <b>QD:</b> Price<br><b>DD:</b> <b>Gain:</b> min(MV at Exercise, Sales Price)<br><b>Loss:</b> Exercise Price (if exercise price > sales price) |
| NQs           | Market Value at Exercise  |
| SSARs         | Market Value at Exercise  |
| RSA           | Market Value at Vest <sup>1</sup>   |
| RSU           | Market Value at Release (often Vest)  |
| 423 ESPP      | <b>QD:</b> Price Paid + Ordinary Income<br><b>DD:</b> Market Value at Purchase  |
| Non-Qual ESPP | Market Value at Purchase  |

<sup>1</sup> if 83(b) filed, cost basis is market value at grant.

## Required Basis Reporting for Stock Plan Shares

| Type     | Actual Cost Basis  | Required to Report |
|----------|--|--------------------|
| ISOs     | <b>QD:</b> Exercise Price<br><b>DD:</b> <b>Gain:</b> min(MV at Exercise, Sales Price)<br><b>Loss:</b> Exercise Price (if exercise price > sales price) | Exercise Price     |
| NQs      | Market Value at Exercise   | Exercise Price     |
| SSARs    | Market Value at Exercise   | Non-covered        |
| RSA      | Market Value at Vest <sup>1</sup>  | Non-covered        |
| RSU      | Market Value at Release  | Non-covered        |
| 423 ESPP | <b>QD:</b> Price Paid + Ordinary Income<br><b>DD:</b> Market Value at Purchase   | Purchase Price     |
| NQ ESPP  | Market Value at Purchase   | Purchase Price     |

<sup>1</sup> if 83(b) filed, cost basis is market value at grant.

## Purchase Cost Basis Example

- Enrollment Market Value = \$10
- Discount % = 15%
- Purchased for \$8.50 when market value was \$20 and immediately sold stock (disqualifying disposition)
- Cost basis = **\$20**
- 1099-B may report cost basis as **\$8.50**

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## Possible Results from Differences

- Participants paying tax twice on spread at exercise / release
- If participants do use correct cost basis, basis will not match 1099-B provided to the IRS
  - Could result in non-compliance notices from the IRS
- General confusion/consternation

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## Optional Basis Reporting

- Broker is permitted to, but not *required* to report
  - “to increase the adjusted basis for the amount (if any) includible as wage income”
  - The *correct* cost basis for the stock plan shares

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## Where will Cost Basis Info Come from?

- Regular sales of shares
  - Broker
    - who bought the shares
    - who transferred the shares
  - Transfer agent
    - where shares are held at TA
- Stock Plans Sales
  - Broker/provider who administers the plan
  - Issuing firm “Transfer Statement”
    - Subject to the same rules/penalties for compliance failure

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## Audience Poll

- Do you contract with a broker who is not your provider or affiliated with your software/system for some of your stock plan transactions?
  - Yes
  - For Execs/insiders only
  - No

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## How Do Brokers Get Cost Basis?

- If your broker administers your plan
  - Has required info / can calculate required info
- If you use one system to administer/track and a different/unrelated broker to deposit shares:
  - Communication to Broker (Broker Instructions) should start to contain cost basis info
    - Reg requires price paid, but consider passing correct basis
    - Some companies use a spreadsheet, add value
    - Others use DWAC form/Fax
    - Talk to your broker about the “agreed upon format”

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## DWAC Instructions

VIA FACSIMILE  
 November 9, 2010  
 Mr. TRANSFER AGENT  
 TA Company NAME  
 TA Company ADDRESS

Re: ABC Company – Restricted Stock Unit Release(s)  
 ABC Company 2008 Stock Incentive Plan

Dear TA Name:

On behalf of ABC Company, Inc., you are hereby authorized and instructed to issue an aggregate of 9,374 shares of the Common Stock of ABC Company, Inc. in the name of **BROKER A** for the benefit of the following individuals as the result of Restricted Stock Unit(s) vest event having the control number set forth below:

| Name   | Control Number | Date of Release | Number of Shares |
|--------|----------------|-----------------|------------------|
| NAME A | 10-092         | 11/9/2010       | 5,833            |
| NAME B | 10-092         | 11/9/2010       | 3,541            |
| Total  |                |                 | 9,374            |

Value \$10.50 Per Share

CONTROL NUMBER: 10-092

Please DWAC these 9,374 shares in a single block free of restrictive legends and stop transfer orders in accordance with the following instructions:

**BROKER A, DTC# XXXX**

If you have any questions, please call me at (XXX) XXX-XXXX.

Sincerely,

Stock Plan Goddess  
 Manager, Stock Plan Administration  
 cc: Broker Name, Broker A

## Do Your Instructions Need to Change?

- “The transfer statement must be furnished in writing unless both the transferor and the receiving broker agree to a different format or method before the transfer.”
- “An applicable person furnishing a transfer statement and a broker receiving the transfer statement may agree to combine the information required in paragraph (b)(1) of this section in any format or to use a code in place of one or more required items.”

## Requirements for Transfer Statement

- (1) In general. Each transfer statement must include:
  - (i) Statement date
  - (ii) Applicable person effecting transfer.
    - Name, address, and telephone number of person furnishing statement
  - (iii) Broker receiving custody.
    - **Name, address, and telephone number** of broker receiving custody
  - (iv) Customers
    - Name and **account number** of customer
  - (v) Security identifiers
    - CUSIP or other security identifier number
    - quantity of shares or units
    - classification of the security (such as stock).
  - (vi) Transfer dates
    - Date the transfer was initiated
    - **Settlement date** of the transfer (if known when furnishing the statement).
  - (vii) Adjusted basis and acquisition date.
    - Total adjusted basis of security
    - the original acquisition date of security,
    - if applicable, holding period adjustment required by section 1091

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## Tax-Qualified Plans

- ISOs & 423-ESPPs
  - Tax basis not known until SALE
    - Same-day Sales are an exception – broker should know cost basis
    - DD / QD
  - If shares are transferred AWAY from broker that has exercise/purchase info
    - Cost basis CANNOT be passed because is it NOT KNOWN
    - One broker planning to pass:
      - ISO - exercise market value
      - ESPP - purchase price
      - (Data required by the new regs)
      - But it will probably be WRONG

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## Penalties

- Penalties *increased* with the passage of the “**Small Business Jobs Act of 2010 (H.R. 5297)**” on 9/27/10
- Failure to file with IRS / Or provide statements to employees
  - Late by 30 days or less: \$30 per form; \$250,000 max
  - Late by >30 days but filed by August 1: \$60 per form; \$500,000 max
  - Filed after August 1 or not at all: \$100 per form; \$1,500,000 max

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## PRACTICAL STEPS

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## Pop Quiz

- Have you spoken to your broker about their plans for cost basis reporting for stock plans?
  - Yes
  - No

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## Broker Plans

- Most brokers/providers reached were planning to track / report correct cost basis
  - Talk to your broker(s) / providers about their plans for cost basis report

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## Broker Communication

- Understand your brokers' plans
  - If planning to report price
    - Encourage your broker to report correct basis instead of "required" basis
    - Tailor participant communication based on this understanding
  - How will "non-covered" securities be shown on the 1099-B?
    - May leave the cost basis info blank

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## Transfer Statement Review / Update

- Does your current method of sending info to your broker have what your broker needs?
  - Consider creating a custom report with all the required information to automate

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## Employee Education

- Start process EARLY
  - Some “incorrect” 1099-Bs will start hitting your participants in early 2012
  - You will be busy with OTHER things in December/January
- Get a sample of new 1099-B from your broker to assist in employee education
  - Many brokers use substitute, aggregate form

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## Employee Education

- Consider new/different formats
  - Long, legal text is often not read/understood
  - Recorded webcasts
  - Email blurbs
  - Small, digestible “chunks” of info, early & often
- New updated/statements?
  - End of Year Tax Summary for more than current year?
  - Retain stock cost basis information online
  - Change wording on statements to say “Cost Basis”?
  - Send new/updated statements for prior years after corporate actions?

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## Employee Education

- Don't pay your taxes twice!
  - Cost Basis MAY not be correct
  - Track the source of your company stock
  - Keep your
    - Confirmations of exercise / purchase / release
      - Generally contain market value at exercise / purchase / release
    - ISOs / ESPP: Forms 3921 & 3922
      - Box 4: Fair Market Value per Share on Exercise Date
- Transferring ISO/ESPP Shares away from "designated broker" breaks link and new broker won't be able to report correct cost basis
  - Keeping shares with designated broker eases tax reporting

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## Contact Information



Elizabeth Dodge, CEP  
 Vice President, Product Management  
 6399 San Ignacio Avenue, Suite 100  
 San Jose, CA 95119 USA  
 Bus: (408) 754-4609  
 Mobile: (650) 773-2142  
 E-mail: [edodge@sos-team.com](mailto:edodge@sos-team.com)



BNY MELLON  
 Andrew Schwartz, CEP, CPA  
 VP, Executive Services  
 480 Washington Blvd Fl 29  
 Jersey City, NJ 07310-2053  
 Bus: (201) 680-3340  
 E-mail: [andrew.schwartz@bnymellon.com](mailto:andrew.schwartz@bnymellon.com)

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