

#### **Cost Basis Confusion:**

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

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# **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

# What Does it Mean for the Securities Industry?

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

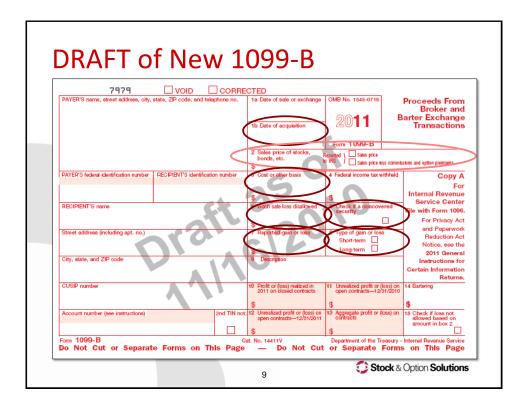
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#### Cost Basis Post-2010

- 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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#### 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

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#### 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...





| Cost | Basis | for | Stock | Pla | n Sha | res |
|------|-------|-----|-------|-----|-------|-----|
|      |       |     |       |     |       |     |

| Туре          | Cost Basis  |  |  |  |
|---------------|---|--|--|--|
| ISOs          | QD: Price   |  |  |  |
|               | <b>DD:</b> Gain: min(MV at Exercise, Sales Price)             |  |  |  |
|               | <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      | QD: Price Paid + Ordinary Income                              |  |  |  |
|               | <b>DD:</b> Market Value at Purchase                           |  |  |  |
| Non-Qual ESPP | Market Value at Purchase                                      |  |  |  |
| Q             | ae. valde ev al elle  |  |  |  |

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

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# Required Basis Reporting for Stock Plan Shares

| Туре     | Actual Cost Basis  | Required to<br>Report |
|----------|--|-----------------------|
| ISOs     | QD: Exercise Price  DD: Gain: min(MV at Exercise, Sales Price)  Loss: 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 | QD: Price Paid + Ordinary Income<br>DD: Market Value at Purchase   | Purchase Price        |
| NQ ESPP  | Market Value at Purchase   | Purchase Price        |

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

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# 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

# **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**

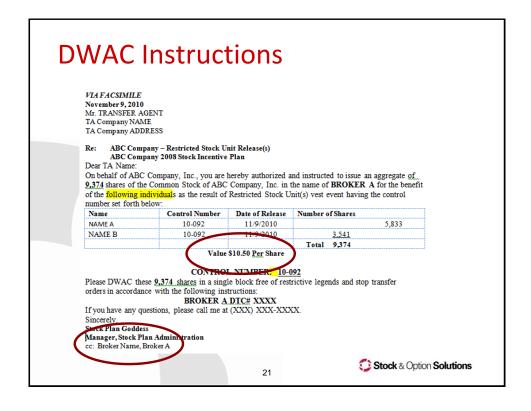
- Do you contract with an broker who is not your provider or affiliated with your software/system for some of your stock plan transactions?
  - Yes
  - For Execs/insiders only
  - No

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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"



### 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





# 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

# **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?

# **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



