Basis Reporting: Lessons Learned and Direction Forward

By Steven M. Rosenthal


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Stockbrokers began reporting sales proceeds and cost basis to the IRS and taxpayers this year. This article describes how those information reports came about and discusses the issues they raise.

Advances in information technology over the last few years offer many opportunities to modernize our tax system. One of them unfolded this spring, as brokers started reporting gross proceeds and basis for stock sales from 2011, to both the IRS and to their customers (the taxpayers). Before, brokers reported sales proceeds to both and sometimes, voluntarily, basis to their customers.

Taxpayers must use the gross proceeds and basis information to calculate their gains or losses for stock sales from 2011. Those gains or losses are reported on tax returns that are due this week. Previously, the IRS could cross-check the amount of sales proceeds that taxpayers reported on their tax returns, but not the basis for the stock sold (and thus not the amount of gains or losses that taxpayers reported). Now, for some sales, the IRS can match both the proceeds and basis reported on the taxpayers' returns with those that the brokers report directly to the IRS.

Congress required brokers to report basis to help taxpayers calculate their gains and losses and to help the IRS verify those calculations (that is, to achieve simplification and compliance goals). Congress expected that brokers could prepare and send these reports efficiently, in light of their technological resources. This article explores what we have learned from the basis reporting experience and how basis reporting can best proceed.

A. Evolution of Basis Reporting

Basis reporting for mutual fund shares originated over 40 years ago, at the initiative of a mutual fund adviser, Investors Diversified Services (IDS) (now known as Ameriprise Financial Inc.), that sought to report gains and losses to its customers. In those days, computer technology was primitive and tax information was rarely sent to customers. Stockbrokers and mutual funds did not report gross proceeds to their customers, or to the IRS, until the enactment of the 1982 Tax Equity and Fiscal Responsibility Act.

In the late 1960s, to help customers calculate their taxes, IDS asked the IRS to permit average basis as an alternative to first-in, first-out or specific identification, which were the only two basis methods permitted.[1] IDS maintained for each of its customers only the total number of shares and the total purchase price of the shares on a computer database, so it could not readily provide FIFO or specific information to its customers. Because of the large data storage expense at the time, IDS did not maintain the purchase price for each lot of shares and the date of acquisition for the lot. If a shareholder needed to know the basis of a specific lot of shares, a customer service representative had to research the shareholder's account in paper files.

In 1970 the IRS proposed to add average basis as a permissible basis method for mutual fund shares under the regulations.[2] The IRS explained:

> The industry has indicated its opposition to any mandatory requirement that a mutual fund make the computations since many small funds do not now use computers. It is anticipated that the growing use of computers

[1]Information obtained from Kitty Taylor, former tax director of IDS (interviewed on Mar. 27).

[2]Prop. reg. section 1.1012-1(e). The code provides that the basis of property is the "cost" of that property, and the regulations prescribe the methods permitted to determine cost. *See* section 1012 and the regulations thereunder.

> would steadily increase the number of funds providing their shareholders with [average basis information].[3]

Although the IRS anticipated that more funds would compute average basis for their shareholders, it did not expect that shareholders would make those calculations on their own, presumably because of their complexity. The IRS finalized the average basis regulation, but for the next 20 years, only IDS calculated gains and losses for its customers.

In April 1990 I devoted a weekend to my taxes, mainly calculating gains and losses from my sales of mutual fund shares, including shares obtained by reinvesting dividends. Although the funds reported the gross proceeds on the sale of my shares to me and the IRS (on the Form 1099-B), they did not report the basis of my shares — either to me or to the IRS. To make matters worse, I discovered that each of my reinvested dividends was a new stock purchase and that each of my redemptions was a new sale — I needed to find the purchase price for each of my reinvested dividends and make hundreds of calculations for my tax return. I spent a lot of time sorting through the mess, even though I used the most basic reporting method: FIFO.

A couple weeks later, in a *Tax Notes* column, economist Gene Steuerle recommended that Congress require mutual funds to calculate gains and losses for their customers, which Steuerle believed could increase revenues for the IRS, simplify reporting for most taxpayers, and lead to more investments in mutual funds.[4] The idea resonated with me, and, as a staffer at the Joint Committee on Taxation, I shared the idea with the staff of the Ways and Means Committee, which was collecting simplification proposals.

Over the next year, we met repeatedly with industry representatives and drafted a proposal to require mutual funds to report sales proceeds, average basis, and holding period information to their shareholders and the IRS.[5] In 1991 House Ways and Means Chair Dan Rostenkowski introduced the basis reporting proposal in H.R. 2735, a simplification bill for the taxation of mutual funds, which was supported, tentatively, by the Investment Company Institute (ICI).[6] Congress passed basis reporting for mutual fund shares in H.R. 11, the Enterprise Zone Tax Incentives Act of 1992, but the bill was vetoed by President George H.W. Bush for reasons unrelated to basis reporting.[7] Rostenkowski later included basis reporting in H.R. 13, the Tax Simplification Act of 1993, and in H.R. 3419, the Tax Simplification and Technical Corrections Act of 1993, which passed the House but not the Senate.

The enactment of basis reporting appeared likely in the early 1990s, and several funds began voluntarily reporting average basis to their customers as the pending legislation would require.[8] After several funds started to report, others followed for competitive reasons. By the mid-1990s, most of the mutual funds calculated gains and losses for their customers, using average basis, without any legislation requiring it.[9] Consequently, lawmakers chose to abandon the basis reporting legislation, principally because they had already largely achieved the simplification goal of mutual funds reporting basis to their shareholders.

In the mid-2000s, Congress again took up basis reporting as it focused more on the tax gap. At that time, brokers reported sale proceeds to the IRS, but not basis, so the amount of gains and losses on sales reported by taxpayers could not be verified. Based on 2001 data, the IRS estimated the revenue loss from the underreporting of capital income at $11 billion annually.[10] To address the tax gap for capital

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[3]Undated technical memorandum for John S. Nolan, Treasury deputy assistant secretary, first published at 1987 W.L. 1363779 (1987).

[4]C. Eugene Steuerle, ''The Mutual Fund Problem,'' *Tax Notes*, Apr. 30, 1990, p. 609.

[5]The taxpayers still could elect to use FIFO or specific identification, so the funds' reports and the taxpayers' returns often would not match.

[6]The ICI strongly supported the repeal of the so-called short-short test (which required funds to receive less than 30 percent of their gross income from the sale of securities held for less than three months), and it tentatively supported basis reporting for mutual fund shares as ''an initial step toward requiring cost basis reporting for investors in all securities.'' *See* statement of Matthew Fink, senior vice president of ICI, before the House Ways and Means Select Revenue Measures Subcommittee (Sept. 17, 1991). By contrast, the Securities Industry Association objected strongly to basis reporting for mutual funds as an unnecessary government intrusion into the marketplace. *See* statement of Jeffrey M. Schaeffer, senior vice president, Securities Industry Association, before the House Ways and Means Select Revenue Measures Subcommittee (Sept. 17, 1991).

[7]H.R. 11 (1992).

[8]DST Systems Inc., the largest provider of third-party shareholder record-keeping services in the United States, first offered average basis reporting for its mutual fund clients in 1992, and by 1995 it was providing average basis reporting for most of its fund clients. Correspondence with Jeff Cook, director of regulatory compliance, DST Systems Inc. (Mar. 30, 2012).

[9]*Id. See also* ICI submission in response to Notice 2009-17, at 4 (Apr. 9, 2009), *Doc 2009-8633*, *2009 TNT 72-16* (a large portion of the mutual fund industry reported basis to shareholders by the mid-1990s). (For Notice 2009-17, 2009-1 C.B. 575, see *Doc 2009-2629* or *2009 TNT 24-10*.)

[10]IR-2006-28, *Doc 2006-2947*, *2006 TNT 31-6*.

gains reporting, Steuerle renewed his recommendation to require basis reporting, which he extended to stockbrokers.[11] At the end of 2005, National Taxpayer Advocate Nina Olson also recommended that Congress require brokers to track and report cost basis for both stocks and mutual funds.[12] She noted:

> When transactions are subject to information reporting to the government, tax compliance is generally very high — well over 90 percent. However, when transactions are not subject to information reporting to the government, the tax compliance rate drops precipitously to a range of about 20 percent to about 68 percent, depending on the type of transaction.

Olson cited a recent article that estimated that the misreporting of gains and losses (from all assets) resulted in the loss of $250 billion in tax revenue over 10 years.[13]

In 2006 then-Senate Finance Committee Chair Chuck Grassley asked the Government Accountability Office to evaluate noncompliance by individual taxpayers for securities gains and losses and to make recommendations. The GAO estimated that 38 percent of taxpayers with securities transactions misreported their gains and losses. Roughly two-thirds of taxpayers underreported, and one-third overreported.[14] The GAO recommended that Congress consider requiring brokers to report basis to taxpayers and the IRS. The JCT staff also offered basis reporting as part of its report, ''Additional Options to Improve Tax Compliance,'' presented at an August 3, 2006, Senate Finance Committee hearing on the tax gap.[15]

In 2006 Sen. Evan Bayh, Sen. Barack Obama, and three others cosponsored S. 2414, the Simplification Through Additional Reporting Tax Act (the START Act). Bayh repeated the IRS estimate of $11 billion of revenue loss for 2001 and projected that it would be $17 billion annually for 2005.[16] Bayh said that by comparison, the brokerage costs of reporting would be modest (''according to a leading company that provides basis tracking services to brokerage firms and mutual funds companies, it typically charges on an annual basis approximately $1 per account''). He added that ''if Fidelity or Ameritrade or E-Trade can provide cost basis information to all of their clients, it clearly suggests that the information can be provided.''

In 2007 President George W. Bush proposed basis reporting by brokers and mutual funds as part of his fiscal 2008 budget, which then-IRS Commissioner Mark Everson later testified was one of the budget's four most important tax-related changes.[17] In his fiscal 2009 budget, President Obama also proposed basis reporting by brokers and mutual funds, which was enacted as section 403 of the Economic Stabilization Act of 2008. The JCT estimated the basis reporting provision would raise $6.67 billion over 10 years.[18]

B. Basic Framework for Basis Reporting

The final basis reporting legislation requires ''brokers'' that have been reporting gross proceeds on the sale of securities also to report the basis of those securities (and to classify any gain or loss as long term or short term) to both their customers and the IRS.[19] Existing regulations define broker as any person that ''stands ready to effect sales . . . made by others,'' which includes traditional stockbrokers and mutual funds.[20]

Congress generally required brokers to use existing methods to calculate basis. Thus, for the sale of stock, brokers must use the FIFO method to calculate basis unless a customer identifies specific lots of shares to be sold at the time of sale. For the sale of mutual fund shares, a broker must use FIFO, specific identification, or average basis, depending on the customer's choice.[21]

Congress phased in the effective dates for basis reporting, reserving the most complicated reporting for last. It set the first phase for reporting basis of stock, effective for stock acquired on or after January 1, 2011. The second phase is for stock for which average basis is permitted (shares in a mutual fund and stock acquired in connection with a dividend

[11]Steuerle, ''Improved Information Reporting for Capital Gains,'' *Tax Notes*, Aug. 8, 2005, p. 697, *Doc 2005-16549*, *2005 TNT 152-36*.

[12]National taxpayer advocate, ''2005 Annual Report to Congress'' (Dec. 31, 2005), *Doc 2006-556*, *2006 TNT 7-11*.

[13]Olson cited Joseph M. Dodge and Jay A. Soled, ''Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question,'' *Tax Notes*, Jan. 24, 2005, p. 453, *Doc 2005-356*, *2005 TNT 15-23*. The authors attributed the misreporting to the complexity of the tax laws, the absence of substantiation requirements, and the lack of compliance incentives (*i.e.*, the absence of third-party information returns).

[14]GAO, ''Capital Gains Tax Gap,'' GAO-06-603, at 3-4 (June 2006), *Doc 2006-11425*, *2006 TNT 114-23*.

[15]*Doc 2006-21526*, *2006 TNT 203-13*.

[16]*Cong. Rec.* at S. 2196 (Mar. 15, 2006).

[17]Statement of IRS Commissioner Mark W. Everson before the House Ways and Means Oversight Subcommittee (Mar. 20, 2007), *Doc 2007-6948*, *2007 TNT 55-45*.

[18]JCX-78-08 (Oct. 1, 2008), *Doc 2008-21047*, *2008 TNT 192-18*.

[19]A nice collection of legislative background, articles, testimony, and comments on basis reporting are *available at* http://costbasisreporting.com/lawlibrary.html.

[20]Reg. section 1.6045-1(a)(1).

[21]Congress also permitted taxpayers who hold stock that is eligible for a dividends reinvestment plan to use the average basis method, apparently at the lobbying of transfer agents that maintain those plans.

reinvestment plan) and is effective for stock that is acquired on or after January 1, 2012. The final phase is for ''other specified securities,'' which includes debt instruments and commodity derivatives, and is effective for securities acquired on or after January 1, 2013, or ''such later date'' as determined by the IRS. Securities subject to the new reporting rules are labeled covered securities, and those that are not are labeled non-covered.

The legislation also added two new information reports: (1) broker-to-broker transfer statements, which generally require a broker that transfers covered securities to a new broker to furnish basis and holding period information to that new broker within 15 days of the transfer; and (2) issuer organizational action returns, which generally require the issuer of a security to file a return that describes any organizational action (like a stock split or a merger) that affects the basis of the security, and the quantitative effect of the action on the basis, within 45 days of the action.

Mindful of the challenges for brokers, Congress delayed the due date for the Forms 1099-B, the information returns that now will include basis information, from January 31 to February 15.

C. Lessons Learned

The long history of basis reporting reveals several lessons.

1. Trade-offs arise with voluntary or mandatory reporting. In 1971 the IRS adopted average basis to help mutual funds calculate gains and losses for their customers. It expected that the number of funds that calculated gains and losses would grow with the spread of computers. However, the IRS overestimated the growth: Only the initial adviser calculated gains and losses for its fund customers over the next 20 years. So liberalizing tax rules alone did not enhance reporting significantly.

Early in the 1990s, Congress introduced legislation to require mutual funds to report average basis, which it expected would help shareholders calculate their gains and losses. Because the basis reporting legislation appeared likely to be enacted, a handful of mutual funds began voluntarily reporting average basis to their customers. By the mid-1990s, most other funds had also begun reporting average basis, again voluntarily. And, as Bayh observed, by the mid-2000s, several stockbrokers were also reporting basis (and gains and losses) to their customers voluntarily. Those brokers used FIFO to report basis, and some adjusted basis for wash sales, corporate actions, etc., but others did not. With a nudge in the early 1990s, Congress triggered the voluntary reporting of basis for most mutual fund customers and later for some stock brokerage customers (achieving substantial simplification for many taxpayers).

Although competitive pressures and technological advances pushed mutual funds and brokers to help their customers with gain and loss calculations, those funds and brokers would not have helped the IRS without a mandate to do so. With the compliance goal in mind, Congress standardized the information that mutual funds and brokers must report. Congress also required taxpayers to provide basis method choices to their mutual funds and brokers or accept default choices. Those steps improved the quality and consistency of the information, which in turn will facilitate information matching by the IRS, but they greatly increased the complexity and expense of reporting.

2. The price of expanding the scope of reporting is large. The final basis reporting legislation was considerably broader than the basis proposals in the 1990s. First, Congress required both stockbrokers and mutual funds to report basis. Second, it required stockbrokers and mutual funds to report a basis method selected by taxpayers, through affirmative election or default, and it required them to use that basis method to calculate their gains and losses. Finally, Congress added new processes to help track basis: broker-to-broker transfer statements and issuer organizational action returns. Those steps greatly help IRS matching efforts; they also shift a substantial administrative burden to the private sector, effectively enlisting the private sector in the tax calculation and reporting process. That burden was much larger than expected.

The demands on brokers, transferors, and issuers to capture, maintain, report, and transmit data are substantial. First they must determine whether a security is covered by the new reporting rules and, if so, how and when.[22] Second, if a security is covered, a broker must solicit and then accommodate customer basis choices (for example, FIFO, average basis, or specific identification). They then must capture and maintain the requisite basis information by tracking individual lot purchases, by both cost and holding period. To report basis correctly, brokers must adjust for wash sales, organizational actions, transfers by gift or death, and other events. Finally, brokers must convey that information to taxpayers, the IRS, and, on transfers, to other brokers. In short, the new reporting regime requires the private sector to design and implement entirely new information exchanges and reporting processes.

[22]Classification of a security can be tricky. For example, depending on its structure, an interest in an exchange-traded fund might be classified as stock, a share in a mutual fund, or a partnership interest, with three different effective dates.

The system and programming demands, information distribution expenses, customer education efforts, and various other burdens are perhaps larger than the annual $1 per account projected by Bayh.[23] The Financial Institute Forum (FIF) estimated the total administrative burden to be $528 million or more for the period 2011-2013.[24] The FIF calculated that burden by extrapolating from data that it collected from a comprehensive sample of large brokers (clearing, discount, and full brokerage), custodians, transfer agents, service bureaus, and solution providers. The FIF's estimated administrative burden exceeds the additional revenue that the JCT estimated would be collected for the same three-year period (although the JCT estimated the revenue would increase over time).[25]

The IRS also has devoted substantial resources to basis reporting. In the Office of Chief Counsel, more than a dozen lawyers from the divisions of financial institutions and products, income tax and accounting, practice and administration, and elsewhere have worked on cost basis reporting. IRS personnel from field operations, the forms department, and the commissioner's office have participated in the guidance process, as have several Treasury tax lawyers.

The IRS started soon after legislation was enacted, but it finished the guidance for the first phase of reporting for stocks only weeks before the effective date. In April 2009 the IRS invited public comments on guidance to help brokers, transferors, issuers, customers, and other affected persons implement the new reporting legislation. It received more than two dozen responses, many quite extensive. In December 2009 the IRS proposed regulations for stock and mutual fund reporting. Again, stakeholders commented extensively, generally complimenting the IRS's outreach and information-gathering efforts.[26]

Notwithstanding the quick start, the IRS did not finalize the first set of regulations until October 2010, only weeks ahead of the start of basis reporting for stock. The guidance project was comprehensive, but the IRS missed its target date for issuing final regulations by one year because of ''unanticipated complexities of the cost basis and transaction settlement industries.''[27]

And although Congress required the new broker-to-broker transfer statements and issuer organizational action returns to take effect with transfers and actions in 2011, its schedule was much too ambitious. In 2010 the IRS announced it would not penalize a broker for failing to furnish a transfer statement in 2011.[28] Late in 2011 the IRS announced it would not penalize issuers who missed the 45-day deadline in 2011, so long as they filed the returns by January 17, 2012.[29] (The IRS itself lagged — it did not publish the forms for issuer organizational actions until January 5, 2012.)

Projecting, and later quantifying, administrative burdens is difficult. But these burdens appear sizeable.

3. Allowing time for brokers and mutual funds to report delays simplification. As noted earlier, Congress delayed the effective dates of the legislation by more than two years and phased in reporting for different classes of securities. Although Congress delayed the start of the reporting regime, it rejected requests to delay it until 18 months after regulatory guidance was finalized, which in light of the delay of the guidance process, might have been substantially later.

Congress allowed more than two years for custodians, transferors, issuers, and the IRS to adjust to the new system. Those stakeholders used that time effectively — the private sector worked hard to develop systems; the IRS worked hard to develop guidance; and both worked to prepare taxpayers for the new reporting system.

For the extended transition period, Congress effectively created parallel reporting regimes for the sale of securities. For example, if a taxpayer acquired stock in 2011 or later (a covered security), a broker must report both gross proceeds and cost basis on the sale of the stock, but if the taxpayer acquired the stock in 2010 or before (a non-covered security), a broker must report only gross proceeds on its sale. As a result, many brokers will report sales of covered and non-covered stock differently — until all the non-covered securities are sold, which might take a while. That parallel reporting system burdens brokers and confuses taxpayers.

Congress could have implemented the regime much earlier and perhaps faster if it had enacted

[23]The total number of accounts is unknown. The ICI estimates that 90 million individual investors own mutual funds, although many of these are IRAs, for which there are not Form 1099-B reports. *Available at* http://www.ici.factbook.org.

[24]FIF cost basis working group, ''Cost Basis Survey III, Final Report,'' at 23 (May 25, 2011), *available at* http://costbasisreporting.com/pdf/FIFCostBasisSurveyIIIReport5-23-11.pdf.

[25]The JCT estimated that relatively little revenue would be collected for the first few years of basis reporting. Seven years after the start of reporting, the JCT estimated an extra $1.7 billion a year would be collected.

[26]GAO, ''Information Reporting,'' GAO-11-557, at 19 (May 2011).

[27]*Id*. at 20 (the IRS target date for final regulations was October 2009).

[28]Notice 2010-67, 2010-43 IRB 529, *Doc 2010-22236*, *2010 TNT 197-11*.

[29]Notice 2011-18, 2011-11 IRB 549, *Doc 2011-3695*, *2011 TNT 36-10*.

legislation in the early 1990s and provided more guidance to brokers and mutual funds on the information they would need to report. Under those circumstances, brokers and mutual funds could have started to collect basis information, and reported after the IRS issued final reporting guidance.

Under the law, brokers and mutual funds may voluntarily report basis information from earlier purchases. IRS regulations permit stockbrokers to report basis for the sale of non-covered securities if the brokers identify the sale as non-covered.[30] Some stockbrokers are doing that.[31] Congress also permitted mutual funds to elect to report average basis for covered and non-covered shares combined.[32] Some mutual funds that have been reporting average basis to their shareholders are expected to make this election.[33]

4. Protecting basis method options for taxpayers complicates reporting. In general, Congress protected taxpayers' ability to select among multiple methods to determine basis, including FIFO, average basis, and specific identification. It also permitted the average basis method for stock that is acquired in connection with a dividends reinvestment plan.[34]

In addition, brokers generally must accommodate their customer basis choices.[35] For stock (other than mutual fund shares), a taxpayer must identify the lot sold at the time of sale, or accept the FIFO basis method. For mutual fund shares, a taxpayer must either identify the lot sold at the time of sale or request the fund to use the average basis method for sales in the future.[36] The IRS also permits a taxpayer to revoke the average basis election or to change from the average basis method, within specified time limits.[37] Otherwise, the taxpayer must accept the fund's default method (which might be FIFO or average basis).[38] For both stock and mutual fund shares, taxpayers may specify the lot sold by giving standing instructions (for example, always sell the highest basis stock).

Some believe the variety of methods confuses taxpayers.[39] For example, for mutual fund shares, taxpayers must now decide whether to provide standing instructions to determine the order in which their shares should be sold (for example, highest basis first), whether to identify specific lots of shares to be sold at the time of sale, whether to elect average basis for their shares (separately for each of their accounts), and whether to revoke or change their average basis elections. I expect most taxpayers will simply ignore their choices.

These multiple choices, however, add considerably to administrative costs, since brokers and mutual funds must solicit, accommodate, maintain, and report the basis choices of their customers. Brokers also must report the basis choices on transfer of the securities.

5. Taxpayers are helped — and confused. The new information reports should simplify tax calculations for many taxpayers. Brokers worked hard to present the new information helpfully and to educate their customers on how to use it. The IRS also issued guidance and designed new forms to report sales, albeit somewhat late in the process.

But taxpayers will find the new system daunting, especially for the transition. This year taxpayers will receive gross proceeds and basis for covered stock but will receive only gross proceeds for non-covered stock. So they will receive different reports for sales of the same stock, depending on the date the stock was acquired. And for non-covered stock, taxpayers must calculate gains and losses on their own (indeed, some brokers who previously calculated gains and losses voluntarily for their customers stopped this year).

In addition, while the IRS allowed brokers some latitude to calculate basis, it did not allow their customers the same latitude. The IRS permits brokers, in reporting basis, to reflect only transactions, elections, or events occurring within the customer's account unless the broker receives additional information from a broker-to-broker transfer return or an issuer statement, which information it may accept as correct.[40] However, taxpayers must apply the law correctly for their tax returns, across all their accounts. The IRS explained:

> Basis reported on Form 1099-B may not reflect the taxpayer's correct basis. For example, brokers need not adjust basis for wash sales unless the transactions that trigger the wash sale occur in the same account with respect to

[30]A broker that chooses to report non-covered securities is not subject to penalties for failure to report the information correctly if it identifies the sales as a sale of non-covered securities. Reg. section 1.6045-1(d)(2)(iii).

[31]Two of my four brokers reported both covered and non-covered securities.

[32]Section 1012(c)(2)(B).

[33]In response to a survey question, almost half of the respondents eligible to use the single account election planned to do so. FIF cost basis working group, *supra* note 23, at 10. The respondents might not fulfill their expectations as they review the quality of their old reports. A fund can make the election only for shares for which it has "accurate basis information." Reg. section 1.1012-1(e)(11)(ii).

[34]Section 1012(d).

[35]Section 6045(g)(2)(B).

[36]Reg. section 1.1012-1(e).

[37]Reg. section 1.1012-1(e)(9)(iii) and (iv).

[38]Reg. section 1.1012-1(e)(2).

[39]*See* Steuerle, *supra* note 4, at 609.

[40]Reg. section 1.6045-1(d)(6)(i).

> identical securities. . . . Taxpayers are expected to report the correct basis on Schedule D regardless of the amount reported on Form 1099-B.[41]

As a result, taxpayers may receive incorrect reports from both brokers, and must then calculate basis on their own. And once taxpayers stop using the numbers that the brokers provide, they must continue to adjust the numbers the brokers provide in the future. Practically speaking, that could be impossible.

Late last year, to accommodate basis reporting, the IRS revised Schedule D and added a new reconciliation Form 8949, which taxpayers must file multiple times. For short-term transactions, a taxpayer must prepare three separate Forms 8949: one for transactions reported on Form 1099-B with basis reported, one for transactions reported on Form 1099-B without basis reported, and one for transactions without Form 1099-B reporting. For long-term transactions, the IRS also requires three additional forms.

Form 8949, which is designed to reconcile differences between the broker and taxpayer returns, requires taxpayers to complete a separate line for each stock sale, whether or not they adjusted the gain or loss information they received from their brokers. Form 8949 also includes extra columns to enable taxpayers to reconcile broker-provided and taxpayer-provided sales information. But completing this new form will challenge most taxpayers.

D. Direction Forward

Brokers, taxpayers, and the IRS still face challenges with basis reporting, but they also may realize opportunities.

1. Allow latitude in transition. The transition to the new reporting system presents the largest challenges. The first phase of information began only this spring. In February stockbrokers distributed their first set of information returns with basis information to customers and the IRS (and began distributing amended returns over the following weeks, as the brokers received corporate action reports). By this week, taxpayers must file tax returns for 2011, which will include new forms to report gains and losses (the revised Schedule D and Forms 8949). These new forms will undoubtedly confuse many taxpayers. They introduce the concept of covered and non-covered securities, as well as the concept that taxpayers and brokers should apply different tax rules for reporting purposes. It is hoped that the IRS will tolerate much of the confusion and misreporting by taxpayers that is likely to result.

The second phase of reporting will begin next year, when mutual funds distribute their first set of information returns. The mutual fund industry should benefit from stockbrokers' experience with their first reporting season and from the final guidance that the IRS put in place last October (for both stockbrokers and mutual funds). However, another set of taxpayers likely will be confused, at least initially.

The IRS continues to prepare for the third phase of basis reporting: the reporting of basis for debt instruments. Reporting basis for debt instruments is more challenging than reporting basis for stock or mutual fund shares. Debt is subject to technically complex rules, including a variety of elections by holders to accrue interest and discount or to amortize premium, many of which can affect basis. Brokers also will struggle to obtain information about the debt that is necessary to determine basis, including the elections of holders (who might not understand their choices). For those reasons and others, brokers have not been reporting gains and losses for debt voluntarily and would have difficulty if required to do so now.

The IRS is now considering comments on proposed regulations for the reporting of basis for debt instruments.[42] Almost uniformly, stakeholders asked for more time to report basis for debt.[43] A delay would be a modest concession because, according to the best available data, relatively little of the tax gap for capital gains is attributable to the misreporting of debt instruments.[44]

Finally, as noted earlier, Congress and the IRS have shifted tremendous administrative burdens to brokers, transferors, and issuers, and we cannot yet

[41]Preamble to T.D. 9504, *Doc 2010-22232*, *2010 TNT 197-10*.

[42]REG-102988-11, *Doc 2011-24609*, *2011 TNT 226-11*.

[43]*See* letters from the American Bankers Association (Feb. 23, 2012), *Doc 2012-5279*, *2012 TNT 50-17*; Bank of New York Mellon, State Street Bank and Trust Co., and the Northern Trust Co. (Jan. 31, 2012), *Doc 2012-1974*, *2012 TNT 22-18*; the Financial Information Forum (Jan. 27, 2012), *Doc 2012-2631*, *2012 TNT 28-34*; the IRS Information Reporting Program Advisory Committee (Feb. 23, 2012), *Doc 2012-5281*, *2012 TNT 50-19*; LPL Financial (Feb. 23, 2012), *Doc 2012-5283*, *2012 TNT 50-21*; Pershing (Feb. 16, 2012), and Securities Industry and Financial Markets Association (Feb. 14, 2012), *Doc 2012-3235*, *2012 TNT 33-33*; I submitted a letter (dated Dec. 8, 2011) on behalf of Wolters Kluwer Financial Services, to request a delay by at least one year in reporting basis for debt instruments (*Doc 2011-25793*, *2011 TNT 237-23*).

[44]Of those taxpayers who misreported securities sales, an estimated 97 percent misreported gains or losses from the sales of stocks and mutual funds, while an estimated 5 percent misreported bonds, options, or futures (some misreported both). GAO, *supra* note 14, at 11.

tell whether the private sector can manage those burdens. The IRS apparently understands the challenges ahead; it reasonably promised to "continue to work closely with stakeholders to ensure the smooth implementation of the provisions in the regulations, including the mitigation of penalties in the early stages of implementation for all but particularly egregious cases."[45]

2. Reduce basis reporting choices. Congress generally protected the basis options that are permitted to taxpayers. Congress even expanded the basis choices for stock acquired in connection with a dividend plan, apparently to accommodate a group of transfer agents who wanted to offer a new service to their customers.

But allowing multiple basis choices undermines the simplicity and the compliance goals of basis reporting. Although Congress has been reluctant to reduce taxpayer choices, that would improve the operation of basis reporting considerably. Brokers could reduce their burden to offer, maintain, revise, and report these different methods. Customers would receive more standardized reports, at the cost of fewer choices.

Setting a single method would reduce many challenges — and the method choice itself is secondary. FIFO is arguably simpler than average basis and might collect more revenue in a rising stock market. However, average basis might better reflect the cost of fungible securities.[46] And if a taxpayer wanted to approximate FIFO or specific identification, he could purchase stock in a new account with the same or different broker (the basis conventions now are applied on an account-by-account basis[47]).

Ironically, the IRS first accepted average basis (for mutual funds) to facilitate basis reporting in light of the large data storage costs for the other methods. Although data storage costs are now low, average basis now has been enshrined in our tax law. Congress should either eliminate average basis or embrace it and reject other basis methods.

3. Focus on helping taxpayers. Basis reports can help taxpayers immensely. Most taxpayers will appreciate having basis information provided to them that can be used easily and will be accepted by the IRS. The IRS should focus on helping taxpayers achieve these goals.

In addition, taxpayers can use basis reporting to expand investment choices. Many taxpayers, like me, have not reinvested dividends because of the difficulty of tracking the basis of the additional (sometimes fractional) shares. Many taxpayers also limit their investing activity just to reduce the complexity of their tax calculations later. Sometimes taxpayers select "all or none" orders to simplify their tax reporting (that is, they instruct their broker that they want an order filled only if they can buy or sell all the shares they told the broker to trade). Now, with the help of stockbrokers and mutual funds, taxpayers may expand their investment practices without fear of the tax calculations later.[48]

Technology often shields taxpayers from the tax calculation process, which is both helpful and harmful — helpful if taxpayers can save time and effort by using the information provided, and harmful if taxpayers cannot confirm or understand the information they have received. For example, a taxpayer might be unable to trace and replicate wash sale adjustments to basis information. Or for mutual fund shares, a taxpayer might be unable to calculate and apportion average basis to shares that have been sold without help (as the IRS anticipated in 1971). This opaqueness might frustrate taxpayers or lead them to reject the information.

In practice, however, most taxpayers simply will transfer the numbers reported to them by their brokers to their income tax returns, and hope for the best. Unfortunately, that might further reduce the transparency of our tax system — a problem that ultimately can be addressed only by simplification efforts.

4. Manage IRS enforcement initiatives. Congress expected that basis reporting would enhance taxpayer compliance considerably, and it anticipated substantial revenue gains. The IRS's expectations also are high: This year it cited basis reporting as one of its "most important initiatives" to address the tax gap.[49]

The IRS's compliance efforts should be carried out in stages. At the start, the IRS should focus on the larger discrepancies between taxpayer and broker returns and determine whether they result from taxpayer mistakes or problems in its own system. There may be many instances in which the taxpayer and broker returns do not match for legitimate reasons. When the basis reported by a broker is incorrect, a taxpayer must adjust the basis reported

[45]Preamble to T.D. 9504, *supra* note 40.

[46]In its fiscal 1997 budget, the Clinton administration proposed that taxpayers determine their basis in fungible securities using the average cost of all their holdings in those securities. *Doc 96-8483*, *96 TNT 56-9*. Congress rejected that proposal.

[47]Section 1012(c)(1) ("the conventions prescribed by regulations under this section shall be applied on an account by account basis").

[48]As Steuerle observed long ago, the tax help might increase the investments in mutual funds (for example, taxpayers might choose short-term bond funds over checking accounts for the higher returns).

[49]IRS release on 2006 tax gap estimates, FS-2012-6, *Doc 2012-344*, *2012 TNT 5-31*.

by the broker and reconcile the difference on the new Form 8949. Form 8949 will be difficult for the IRS to review automatically. Over time, the IRS should identify the taxpayer variables that account for the differences and determine whether those differences are worth investigating.

For computer-generated audits, the IRS must develop appropriate routines. Presumably, the IRS will first send relatively few error letters and then expand its reach. Ultimately, it should investigate only differences that matter. Hopefully it will tolerate small differences in amount without generating automatic audit contacts.

Prior experience with information returns shows that most of the increase in compliance may be attributable to the deterrent effect of the basis reports (which allow the IRS to verify gains and losses, whether it chooses to do so or not). As a result, the IRS should proceed cautiously in pursuing taxpayers.

E. Conclusion

Advances in information technology present both challenges and opportunities, as demonstrated by the 40-year history of basis reporting. Many challenges still lie ahead, although expectations of simplification benefits and compliance gains continue to be high. The question remains whether simplification benefits and compliance gains justify the reporting burdens. I believe the answer is yes, although the transition will be difficult. To help, the Congress should simplify the law and the IRS should tolerate minor reporting discrepancies.