Understanding Cost Basis Reporting Regulations

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Contents

Executive Summary

The Emergency Economic Stabilization Act (the Act) was signed into law in October 2008. It requires the financial services industry to provide cost basis and detailed gain and loss information to investors on Internal Revenue Service (IRS) 1099-B forms. The tax rules have been phased in over time, beginning with stocks in 2011, mutual funds and dividend reinvestment plans (DRPs) in 2012, less complex debt (bond) instruments and options in 2014, more complex debt in 2016, and transfer statement reporting in 2017.

Firms responsible for this Treasury Department and IRS requirement must continue to comply with the rules or risk potential penalties. Affected firms must be prepared to record cost basis of acquired securities for tax purposes, provide investors with the ability to elect and change lot selection methods, and differentiate reporting and processing of covered and noncovered securities. They also must calculate and tax report certain wash sales, change timing of short sale reporting and backup withholding, and monitor and determine the effect of corporate actions on the cost basis of security positions.

A challenge facing U.S. financial services firms, including brokers,[1] has been managing complex securities transaction types, each of which comes with its own set of issues and implications. Wash sale calculations, for example, require cost basis and holding period adjustments that are often quite detailed. Short sales need to be reported during the tax year the sales are closed, not the year they are opened. Mutual funds and covered equity DRPs are allowed to use the average cost basis method, with first-in, first-out (FIFO) provided as a default disposition method for these average cost positions.

On average cost accounts, most, if not all, financial services firms, when calculating average cost, elected to segregate pre-2012 and post-2011 positions rather than to bifurcate the positions into covered and noncovered shares for accounts using cost basis.

For many firms, updating systems to ensure compliance with the regulations is being done by outsourcing providers like Pershing, a BNY Mellon company. Pershing has developed a comprehensive cost basis reporting strategy to ensure our clients are properly prepared.

This guide focuses on the following financial services firms which were affected by cost basis regulations. These include, but not limited to, securities clearing organizations, brokers and broker-dealers, banks, mutual fund companies, custodians, issuers/transfer agents, (corporate stock) plan administrators, advisor firms and registered investment advisory firms.

[1] This guide defines brokers as firms required to provide Form 1099-B reporting.

Introduction

The IRS presumed that vital tax dollars were lost every year as a result of taxpayers incorrectly reporting their capital gains and losses on the securities they had purchased. To minimize this, the cost basis reporting regulations required U.S. financial services firms to provide cost basis and detailed gain or loss reporting for the first time in 2012.

Beginning in 2012 for 2011 tax year reporting, certain U.S. financial services firms were required to report adjusted cost basis, holding period information and certain wash sale information on investors' Form 1099-B for covered shares of stock.

Cost Basis 101—A Brief Description

At its most basic level, cost basis is the original purchase price of a security, plus fees and commissions of covered securities (that is, securities acquired on or after the applicable effective date, as opposed to noncovered securities). In addition to reporting gross proceeds, certain U.S. financial organizations are now required to report the original (or the adjusted) cost (the cost basis of the security sold), the gain or loss on the sale, whether the gain or loss is long-term or short-term and whether any reported loss is disallowed due to the special application of the wash sale rules.

Cost basis may be adjusted for a number of factors, including corporate actions (such as stock splits and mergers), wash sales and dividend adjustments, and the firm generally is required to report the adjusted cost for all sales. The following is a breakdown of basic steps and key factors related to calculating adjusted cost basis:

Steps	Key Factors/Issues
Determine Original Cost Basis	› If purchased: Price paid plus costs › If acquired by gift: Carry over basis or the fair market value on the date of the gift › If inherited: Value is provided by the estate representative or defaulted to fair market value as of the date of death
Adjust for Corporate Actions	› Includes mergers, acquisitions, spinoffs, stock rights, splits and dividends › Voluntary corporate actions and mergers should be handled at account level › Complete data is essential, including for foreign securities

Steps	Key Factors/Issues
Adjust for Wash Sales (or Short Sales)	› Wash sales: Tax sub-lots must be created and tracked and holding period adjusted › Short sales: Complex and challenging to accurately account and report
Determine Gain/Loss	› Must track and report the amount and character of gain/loss (and disallowed loss due to the special application of the wash sale rules) for all covered securities sold

Under the legislation, certain U.S. financial services firms are required to report investors' cost basis when securities are sold. Previously, firms were only required to report gross proceeds for such transactions. Further, firms not only have to report cost basis for the covered securities sold, but also whether the sales are short-term gains or losses—for holdings of a year or less—or long-term gains or losses. Long-term gains are taxed at capital gains tax rates, while short-term gains are taxed at higher ordinary income tax rates. The effective dates for which cost basis must be reported are as follows:

Reporting Requirement	Effective Date
Stock in a corporation	January 1, 2011
Mutual fund shares, including eligible dividend reinvestment plan (DRP) shares and exchange-traded funds (ETFs) that are treated like mutual funds	January 1, 2012
Less complex debt instruments (bonds) and options	January 1, 2014
More complex debt instruments, including bonds with more than one rate, convertible bonds, stripped bonds or stripped coupons, payment-in-kind (PIK) bonds, foreign debt, foreign currency debt, some private issues and physical certificates	January 1, 2016*

* Transfer statement reporting for less complex debt and options, which was delayed to 2015, became effective as of January 1, 2015. Transfer statement reporting for more complex debt is delayed to 2017.

The Impact to the Financial Services Industry

The tax rules impacted all participants, including Pershing,[2] in the financial services industry that issue Form 1099-B. This includes securities clearing organizations, brokers, banks, custodians and mutual funds. Other financial services participants, such as (corporate stock) plan administrators and transfer agents, are required to issue transfer statements under the new tax rules reporting the transfer of covered and noncovered securities, but not Form 1099-B tax reports.

[2] Pershing is responsible for Form 1099-B reporting and transfer statements for all U.S. fully disclosed brokerage accounts.

Here is how key industry participants were impacted:

DTCC

The Cost Basis Reporting Service (CBRS) is an offering by DTCC Solutions LLC. This service was previously linked to the Automated Customer Account Transfer Service (ACATS) and passes cost basis from broker to broker when an ACATS transfer occurred. With the legislation, DTCC was challenged by the industry to expand the CBRS beyond the ACATS service and have it become the central hub for passing on cost basis for all security movements.

Custodians and Securities Clearing Organizations including Pershing

Pershing has used the CBRS system from inception and has modified its systems to be compliant with each year's enhancements. Among the biggest challenges faced by reporting financial organizations was integrating with all industry players and all the new and existing cost basis systems. While progress has been made, there are still issues with debt and options.

Issuers and Transfer Agents

Issuers and transfer agents currently control all the physical certificates and maintain direct registration accounts (DRS) for millions of investors. In 2011, they were required to maintain cost basis for the first time and pass it on to the executing firm. What this means is cost basis for physical certificates remain at the agent not the broker even when securities are held in physical form at the broker (safekeeping). Cost basis information provided by clients may be overlaid by an issuer or agent upon cancellation of the physical certificate.

Note: In almost all cases, issuers and transfer agents were not storing cost basis information because they were not subject to the cost basis rules until 2011. If transfers occurred from these entities, clients will not receive cost basis if the acquisition date was before 2011.

Banks

Banks typically transfer accounts outside of the ACATS service. When the legislation became effective, banks were required to also provide cost basis reporting information and will likely look to use a more automated method.

(Corporate Stock) Plan Administrators

When companies issue stock as compensation, Pershing has typically relied on the recipient of the compensation to provide the cost basis. With the changes, many plan administrators had to develop ways to calculate cost basis and pass it along with the securities.

Mutual Fund Companies

Mutual fund companies were not subject to the cost basis rules until 2012, when they were required to develop a method for maintaining and passing on cost basis information for firms not on the ACATS service.

Advisors and Registered Investment Advisors

Advisors and registered investment advisors were challenged to explain a number of nuances of the legislation to their clients. These included why some items are subject to cost basis reporting and others are not. For example, why wash sale rules are applied differently for Form 1099-B and tax return reporting purposes, and when short sales are reported. In 2014, this group was challenged to explain the complex elections for bond amortization and accretion.

Investors

Investors no longer have the luxury of deciding which lots they want to apply to each sale trade at the time they calculate gains and losses on the sold securities. They now must decide which lots to apply to a sale generally no later than settlement date, as Pershing will report cost basis for the sold lots on Form 1099-B.

Pershing's Tax and Cost Basis Systems

Over the past few years, Pershing has done extensive remediation to its systems. Key enhancements are highlighted below:

- Allowing investors to select tax lots at time of trade and up to and including settlement date
- Notifying investors of the tax lots to be disposed
- Enabling investors to select and change their position methodology of disposing of tax lots
- Differentiating processing of covered and noncovered securities, DRPs and non-DRPs
- Enhancing Form 1099-B to capture all cost basis updates
- Reporting on wash sales including the disallowed amounts and reporting short sales at the time the sale is closed rather than when opened
- Tracking corporate actions to adjust cost basis on current positions and transferred positions

Pershing has also updated its systems in NetX360®

- Selecting Tax Lots—Pershing expanded its online service to allow for the selection of tax lots for partial bond and option dispositions at either the point of trade or the asset movement entry, or up to and including settlement date.
- Passing Tax Lots—Pershing continues to use DTCC's CBRS to transfer cost for all security movement types that occur throughout the industry.
- Notification Enhancements:
  - Expanded the standard files for each phase of the regulations.
  - Added the disposition method to the trade confirmations and debit advices.
  - Provided its clients with the option of displaying expanded cost basis reporting, allowing investors to review their potential tax picture throughout the year.

Need-to-Know Information—Complex Transactions

Dealing with complex transaction types and ensuring compliance with the cost basis reporting requirements remains a real challenge. Among those are corporate actions, gifts and inheritances, lot relief methods, mutual funds and DRPs, short sales and wash sales. Each of these is briefly highlighted below.

Corporate Actions

Corporate actions include taxable and non-taxable events that affect a company's capital structure, such as stock splits, reverse splits, stock dividends, spinoffs, mergers and tender offers. Such activity can affect the basis and holding period of stocks and securities, triggering recognition of gain or loss for the investor. Rules enacted as part of the cost basis legislation require issuers to report publicly on the quantitative effect of their corporate actions. This, in turn, requires certain U.S. financial organizations to monitor reported information through a potentially manual intensive process.

Gifts and Inheritances

Securities that are gifted or inherited generally keep their original covered status at the time of transfer. The cost basis for these shares may be determined by special valuation rules. For inherited shares, the legal representative of the estate must provide the date of death or alternate valuation date values as determined for federal estate tax purposes or the reporting financial organization will apply the fair market value as of the date of death upon transfer from the decedents account. Pershing has created a special form to assist clients with capturing all of the required information needed on complex death scenarios (e.g., trusts accounts). For gifted shares, the donor's original cost basis and the fair market value of the shares on the date of the gift will be used for transfer statement purposes.

Lot Relief Methods

A lot refers to a block of information on the purchase of a security that includes a unique pre-unit date, cost and number of shares that distinguishes it from all other purchases (it is typically a single buy transaction). To compute the gain or loss of securities sold, the proper lot (or lots) of securities held by the investor must be determined—a process referred to as lot relief. Lot relief methods include FIFO, specific identification of lots, averaging and various selection methods.

The tax rules require firms to use FIFO or average as the default lot selection method for all sales of covered stock unless the investor requests to change from the FIFO method to another permitted and offered lot selection method. Under the cost basis reporting requirements, investors must identify and communicate the lot selection method to be used in connection with sale of stock generally no later than the settlement date (or the time for settlement under SEC rules, if earlier). Otherwise, the default lot method must be used to determine cost basis for calculating gain or loss on the sale to be reported on Form 1099-B.

For mutual fund and DRP shares, the default lot selection method now applies to covered mutual funds or DRP shares, except where the investor elects the average cost or other permitted methods for such covered shares. In average cost, the lots are disposed of in FIFO order and the special single account election belongs to certain financial organizations, not the investor.

Mutual Funds and Dividend Reinvestment Plans (DRPs)

Mutual funds and DRPs are eligible for the average cost basis method. A dividend reinvestment plan does not qualify as a DRP for cost basis reporting purposes unless at least 10 percent of dividends are required to be reinvested. Investors who elect the average cost basis method for either mutual funds or DRP shares have the option to revoke the election. In certain circumstances, the rules permit the financial organization, not the investor, to make a single account election, which will combine all pre-2012 acquired shares with all post-2011 acquired shares as covered shares for cost basis reporting purposes. If the single account election is not made, the shares acquired before 2012 and those acquired after 2011 will be bifurcated, and split into noncovered and covered shares for cost basis reporting purposes.

Short Sales

A short sale occurs when a borrowed security is sold, and the short position is maintained in the investor's account. Under new short sale rules, the reporting of the short sale moved to the time when the investor acquires the stock to close the short position and the position is closed. At that point, the short sale becomes reportable on Form 1099-B.

Wash Sales

Due to cost basis changes, a reporting financial organization must calculate a wash sale when a covered security is sold at a loss and an identical security (bearing the same CUSIP) is purchased or acquired in a taxable transaction in the same brokerage account during the 30-day period before or after the sale. In that case, the disallowed loss will not be reported but it will be moved to the cost basis of an existing tax lot. Firms are also required to adjust the holding period of the reacquired securities. Under current tax rules, numerous scenarios can create wash sale events—Pershing estimates there are more than 40 wash sale scenarios.

Note: In many cases, cost basis reported on Form 1099-B may not reflect the taxpayer's correct cost basis information. For example, brokers need not adjust cost basis for wash sales unless the transactions that trigger the wash sale occur in the same account with respect to identical securities. Additionally, brokers are permitted, but not required, to report cost basis for noncovered securities. Taxpayers are expected to report the correct cost basis on Schedule D and IRS Form 8949 regardless of the amount reported on Form 1099-B.

Debt (Bond) Instruments

For debt (bond) instruments, the IRS decided on a phased approach of cost basis reporting with less complex bonds in 2014 and more complex bonds in 2016. Listed below are the definitions as outlined by the IRS, including illustrative examples.

Less Complex Bonds

The IRS classifies less complex debt instruments as follows—a bond that provides for a single fixed payment schedule for which a yield and maturity can be determined for the instrument under §1.1272-1(b), a debt instrument that provides for alternate payment schedules for which a yield and maturity can be determined for the instrument under §1.1272-1(c) (such as a debt instrument with an embedded put or call option), and a demand loan for which a yield can be determined under §1.1272-1(d).

Complex Bonds

Complex bonds for 2016 include:

- A debt instrument that provides for more than one rate of stated interest (including a debt instrument that provides for stepped interest rates)
- A convertible debt instrument described in §1.1272-1(e)
- A stripped bond or stripped coupon subject to section 1286
- A debt instrument that requires payment of either interest or principal in other than U.S. dollars
- A debt instrument that, at one or more times in the future, entitles a holder to a tax credit
- A debt instrument that provides for a payment-in-kind (PIK) feature (that is, under the terms of the debt instrument, a holder may receive one or more additional debt instruments of the issuer)
- A debt instrument issued by a non-U.S. issuer
- A debt instrument for which the terms of the instrument are not reasonably available to the broker within 90 days of the date the debt instrument was acquired by the client
- A debt instrument that is issued as part of an investment unit described in §1.1273-2(h); or a debt instrument evidenced by a physical certificate unless such certificate is held

Bond Elections

A reporting financial organization is required to report the adjusted basis of a debt instrument that is a covered security. Under the cost basis changes, the holder of a debt instrument is permitted to make a number of elections that affect how basis is computed. The table (see below and next page) outlines cost basis bond elections and provides a brief description of each election.

Elections	Description
Required Amortize bond premium on nontaxable bonds in accordance with Internal Revenue Code (IRC) *IRC section 171*	All bond premium on tax free bonds is required to be amortized using the constant yield method to the worst call date.
Election 1. Bond Premium Amortization Amortize bond premium on taxable bonds *IRC section 171(c)*	The IRS default is to amortize the bond premium and calculate using a constant yield method to the maturity date.
Election 2. Market Discount Accrual Method To accrue market discount on a constant yield *IRC section 1276(b)(2)*	The new default method accrues market discount using the constant yield method. In 2014, the default was ratable (straight line). Prior to 2014, Pershing's default was constant yield.
Election 3. Include Market Discount as Income To include accrued market discount as income annually, referred to as current inclusion election *IRC section 1278(b)*	The default does NOT include accrued market discount annually as income on IRS Form 1099; instead the default recognizes the accrual upon disposal. In these cases, the accrued discount is reported on Form 1099-B for covered transactions.

Elections	Description
Election 4. Original Issue Discount (OID) To treat all interest as OID *IRC section 1272*	The IRS no longer requires reporting financial organizations to maintain the Treat All Interest as OID election beginning with the 2015 tax year. This election has been removed as an option. If OID was previously selected, investors should meet with their tax professionals to determine which election best suits their financial situation.

Pershing added these elections at the account level. The election must be selected by the tax payer and the defaults have been set by the IRS and cannot be changed without written instructions from the tax payer.

Comparing Election Strategies

Market Discount Elections and Illustrations

Before purchasing any bonds with market discount, the client should have already decided how they want to calculate accruals and when they want to realize the market discount income. Let's look at a simple example and show the effects of these elections.

Example: Client A purchases a $100,000 bond that matures in five years. The purchase price of the bond or cost basis was $95,000. Therefore, that bond was purchased at a $5,000 market discount—meaning if held to maturity Client A will receive an additional $5,000. The reporting financial organization is responsible for reporting the $5,000 of income generated from the market discount.

Assume in the example that Client A is deciding between Election 2 (Market Discount Accrual Method) and Election 3 (Include Market discount as Income) annually. The client's election will impact how the reporting financial organization does those calculations.

If Client A does not make Election 3, which is to include income annually, the $5,000 (assuming the bond is in good standing and held to maturity), then the income will be reported as taxable income the year the bond matures on form 1099-B.

If Client A makes Election 3, the reporting financial organization will be required to calculate the annual accruals and report them on the 1099-INT as interest income each year the bond is held. The amount reported yearly will be dependent on Election 2 (which is shown below).

If Client A elects Election 2 (Market Discount Accrual Method), this election determines the method that a reporting financial organization will use to calculate the accrual of the market discount. As a default, the IRS requires reporting financial organizations to calculate accruals by using the constant yield or scientific method, which considers the value of money over time and the accruals are smaller in the earlier years and greater as the bond gets closer to maturity. However, Client A may make even payments or accruals across the life of the bond. This is the ratable or straight line method.

The following tables (below) show that same client's bond accruing over five years using the two different methods. Note that these payment examples are for illustration purposes only.

Constant vs. Ratable Example Bond	Purchased 01/01/2014 @ 95 for 5 Years	Coupon 5%
Purchase Settle Date	Maturity Date	Constant Yield Rate
01/01/2014	01/01/2019	6.17%
Coupon Rate	Quantity	Original Cost
5.00%	1,000.00	$950.00

Constant Yield	Annual Payment (Current Inclusion)	Accumulated Income
Year 1 Income or Accrual	$8.82	$8.82
Year 2 Income or Accrual	$9.37	$18.19
Year 3 Income or Accrual	$9.97	$28.16
Year 4 Income or Accrual	$10.59	$38.75
Year 5 Income or Accrual	$11.25	$50.00

Ratable/Straight Line	Annual Payment (Current Inclusion)	Accumulated Income
Year 1 Income or Accrual	$10.00	$10.00
Year 2 Income or Accrual	$10.00	$20.00
Year 3 Income or Accrual	$10.00	$30.00
Year 4 Income or Accrual	$10.00	$40.00
Year 5 Income or Accrual	$10.00	$50.00

Bond Premium

Illustration 1 (next page) outlines the calculation and reporting of bond premium amortization and interest payment offsets. If an investor purchased a taxable bond with a $1,000,000.00 face at a premium to par value for $1,032,515.00, the bond was purchased at a bond premium of $32,515.00. Even though the bond was purchased for $1,032,515.00, the investor will only receive par value, $1,000,000.00 in return at maturity on 03/15/2019. One reason the bond may be trading at a premium is if the coupon rate may be larger than newly issued bonds of comparable characteristics and risk, keeping the market in equilibrium.

Since the investor paid a premium for the bond, he or she is allowed to adjust, also known as amortize, the premium down to par value over the life of the bond. The amortization calculated at the time of each interest payment may then be used to offset a portion, or all, of that interest payment. Therefore, the investor would only have to pay income tax on the net difference. This bond premium interest offset is to be reported on Form 1099-INT in Box 11, whereas the interest payment itself would be reported in Box 1 of the same form.

Illustration 1—Bond Premium

Transaction	Settle Date	Quantity	Cost/ Proceeds	Coupon	Maturity
BUY	03/31/2014	1,000,000	$1,032,515.00	8.875%	03/15/2019
SELL	02/10/2016	1,000,000	$1,020,000.00	–	–

Note: Amortization is calculated on taxable bonds using the constant yield to maturity method. Nontaxable bonds must use constant yield to worst call or maturity to calculate amortization interest offsets.

In Illustration 2 (next page), coupon payments pay on 03/15/2015 and 09/15/2015 each year for an amount of $44,375.00. However, tax year 2016 has prorated accrued interest on the Sell Trade for $36,486.00 which can also be offset by amortization. Interest payments are to be reported on the 1099-INT in Box 1.

On 09/15/2014, the investor received the first coupon payment of $44,375.00. The amortization as of 09/15/2014 is $2,493.77. The investor can report the $2,493.77 amortization interest offset on Form 1099-INT in Box 11. The cost basis on the bond may then be reduced by this amortization from $1,032,515.00 down $2,493.77 to $1,030,021.23. Since the 09/15/2014 interest payment was the last interest payment received in 2014, the amortization that has taken place of $1,861.23 between 09/15/2014 through 12/31/2014 cannot be reported in 2014.

In 2015, two interest payments are received on 03/15/2015 and 09/15/2015.

- On 03/15/2015, the unused amortization as of 12/31/2014 of $1,861.00 plus the amortization from 12/31/2014 through 03/15/2014 equals $2,833.23. This amount can be used to offset the 03/15/14 interest payment.
- On 09/15/2015 another payment is received, and the amortization from 03/15/15 through 09/15/2015 of $2,947.00 is used as an offset.

On 12/31/2014, a total Interest amount of $88,750.00 is to be reported in Box 1 of Form 1099-INT and a total amortization of $2,833.23 + $2,947.00 = $5,780.23 is to be reported in Box 11 of the same form.

When the bond is sold on 02/10/16 accrued interest of $36,486.00 on the sale is reported with an offset of $2,613.00 which is the amortization from 09/15/2015 through 02/10/2016. The client may elect to not amortize his or her taxable bond premium. However, nontaxable bond premium must be amortized.

Illustration 2—Bond Premium

Tax Year	Adjusted Cost	1099-INT Interest Income Box 1	1099-INT Bond Premium Box 11	Unused (not reportable) Amortization
09/15/2014	$1,030,021.23	$44,375.00	$2,493.77	–
12/31/2014 Total	**$1,028,160.00**	**$44,375.00**	**$2,493.77**	**$1,861.23**
03/15/2015	$1,027,188.00	$44,375.00	$2,833.23	$0
09/15/2015	$1,024,241.00	$44,375.00	$2,947.00	$0
12/31/2015 Total	**$1,022,215.00**	**$88,750.00**	**$5,780.23**	**$2,026.00**
02/10/2016 Sale	$1,021,628.00	$36,486.00	$2,613.00	$0

Options

Options became reportable in 2014. Since 2011, Pershing has been adjusting proceeds and cost for options as required. That means upon assignment or exercise Pershing has adjusted either the cost or proceeds of the underlying securities.

As an additional service, Pershing also provided detailed information to our clients on the cash settlement and expiration of options even before that information was required to be reported to the IRS. Effective 2014, the buys, sells and expirations are now reported to the IRS.

The industry has requested a change on how written options are treated when a buy to cover occurs. The cost basis will always be considered $0 and the proceeds will be the difference between the sell amount and the amount spent to buy the option back. See instructions below from the IRC for more information on reporting options.

(ii) Cash settlement. For purposes of paragraph (d) of this section, for an option that is settled for cash, a broker must reflect on Form 1099-B all payments made or received on the option. For a purchased option, a broker must report as basis the premium paid plus any costs (for example, commissions) related to the acquisition of the option and must report as proceeds the gross proceeds from settlement minus any costs related to the settlement of the option. For a written option, a broker must report as proceeds the premium received decreased by any amounts paid on the option and report $0 as the basis of the option.

1256 Options

Pershing will not be making any changes to how 1256 options have been reported. However, Pershing began passing and receiving the mark to market data on 2016 on transfer statements. Further, Pershing will consolidate the prior firms mark to market reversal when the options are sold.

Conclusion

The Cost Basis Reporting Regulations were passed into law in 2008. The general intention of the rules is for reporting financial organizations to report cost basis and capital gains activity that occurred on their books to the IRS. Within the tax rules, the IRS specifically incorporated modified gifting rules, modified inheritance rules and modified wash sale rules.

However, due to these cost basis changes, inconsistency in reporting practices among reporting financial organizations and their clients has been noted by the IRS. The IRS clearly understands that some taxpayers could take advantage of other rules or exceptions (and adjust their reportable basis from what a financial organization reports). To accommodate inconsistency between financial organization reporting and individual reporting, the IRS introduced a new tax form in 2015—IRS Form 8949—that clients should utilize for their reporting.

It is our opinion that activities that occur outside the brokerage platform (like the ones noted in the above paragraph) that impact cost basis are adjusted on Form 8949 and fully disclosed by the taxpayer to the IRS.

To further ensure our clients are prepared, Pershing continues to work with the industry to develop a comprehensive cost basis reporting strategy. Look for additional communications from Pershing about cost basis regulations.

For more information, please visit Pershing's Cost Basis Information page via Tax Reporting Tools and Resources in Marketing Center in NetX360.

Glossary

15-day Rule	Applies to transfers of cost basis information. For covered securities, the transferring firm has 15 days to transfer cost basis and other required information after the transfer of securities.
45-day Rule	Issuers of securities are required to report corporate actions on IRS Form 8937 no later than 45 days after the date of the corporate action or January 15, of the following calendar year, whichever is earlier. The issuer is required to include a description of the action and the effect on cost basis.
Accrued Original Issue Discount (OID)	This is the net value of OID reported per year on the 1099-OID Box 1 for corporate taxable bonds and Box 8 for government bonds. Tax exempt bond OID reported in the non-reportable section. The value displayed in this field is the year-to-date accrued OID for the bond, and it will be populated on all OID bonds.
Acquisition Premium	This is the value of acquisition premium which may be net against the reportable OID on a bond purchased above the OID price yet below par value. This value must be reported on the 1099-OID Box 6.
Automated Customer Account Transfer Service (ACATS)	The term concerns the transfer of securities from one brokerage account to another account at a different brokerage firm or bank. The transfers are automated and include transaction and security information.
Book-Entry Shares	Securities that are recorded on transfer agency books in electronic records called book entries rather than as paper certificates.
Certificate (Physical)	Refers to securities that are physically issued in paper form. The presentation of a certificate for sale is by definition Specific Identification of Lots (see page 17). Certificated securities may represent multiple underlying purchase lots that require tracking.
Corporate Actions	Includes taxable and non-taxable events that affect a company's capital structure. Can include stock splits, reverse splits, stock dividends, spin- offs, mergers and tender offers. Corporate actions can affect the basis and holding period of stocks and securities held triggering recognition of gain or loss for the investor. Improper adjustments can result in errors that can adversely affect computations of taxable gain or loss.
Cost Basis Reporting Service (CBRS)	It is the industry standard for electronically transferring cost basis information from one financial organization to another when accounts are transferred.
Covered Securities	Refers to securities that are purchased or acquired after the effective date (for stocks, January 1, 2011). Depending on the security type, cost basis reporting is generally required.
Debt Securities	These are securities representing debt or fixed income payment obligations, such as bonds and other forms of commercial paper. The cost basis of debt instruments is dependent on amortization/accretion requirements. The effective date for these securities is based on the complexity of the bond and will either be covered January 1, 2014, or January 1, 2016. Please see the section above.
Deferred Income	The value populated in this field represents the total "purchase to date" market discount accrual. This accrual is tracked separately from the bond's cost basis since its reporting is deferred until the time of sale or maturity. Deferred Income will be used as an offset to the unrealized gain or loss. When realized, this value will be reclassified as "Reportable Income." As default, this field will be populated when bonds are purchased at a market discount provided that the investor does not elect to include market discount accruals in income annually. This value is not reported to the IRS in its unrealized state. However, it will be used to populate Form 1099-B Field 1G as reportable income when the bond is sold or matured.

Deposit/Withdrawal at Custodian (DWAC)	This is a real-time method for moving shares to/from transfer agents and DTCC participants. Uses a matching system where the participant initiates the request, and the transfer agent approves it after matching the share total and participant's name. A DWAC deposit is a movement of shares from the transfer agent to the participant. A DWAC withdrawal is a movement of shares from the participant to the transfer agent. In both scenarios, cost basis may have to be provided, if known.
Dividend Reinvestment Plan (DRP)	This is a program in which the shareholder elects to have dividends reinvested for additional shares. These additional purchases may be full or fractional shares. Each dividend reinvestment event is considered a separate purchase.
Direct Registration System (DRS)	This is a system for book-entry ownership. It is a service in which shares are owned, recorded and transferred electronically without issuing a physical share certificate. Instead of being represented by a physical share certificate, shares are held in registered form and recorded electronically on the books and records of the transfer agent.
Direct Stock Purchase Plans (DSPPs)	These plans permit investors to regularly acquire shares and fractional shares of particular securities. These plans may allow the investor to purchase shares at a discounted price. Investors generally hold these securities on a long-term basis.
Employee Stock Purchase Plans (ESPPs)	These plans allow employees to purchase shares and fractional shares of their employer via payroll withholding and through other direct stock purchases. Some plans permit discounted purchases. Plans may be tax qualified under Internal Revenue Code (IRC) Section 423 or non-qualified. See also DRPs and DSPPs (above).
Fast Automated Stock Transfer (FAST)	A DTCC system through which financial organizations can request physical certificates for investors. The "street" positions are all held at the transfer agent. The process involves debiting the shares and crediting an individual shareholder account. Cost basis would have to be provided by the DTCC participant to the transfer agent on the CBRS file. Some issues are not "FAST" eligible, so cost basis information may need to pass manually.
Foreign Securities	These are securities that are issued by foreign corporations, entities, etc.
Holding Period	This represents the ownership period for a particular asset or security. Holding periods include both short-term and long-term periods. See also long-term and short-term securities (below).
Internal Transfer	These are transfers that occur within accounts held at Pershing.
IRS Form 1099-B	IRS form used to report sales proceeds (e.g., gross proceeds) from the sale of securities acquired on or after the effective dates. Cost basis, gain or loss and holding period information and wash sale results will be reported on the form.
Long Sale	This is a transaction involving the sale of security, where the security is owned before the date of sale.
Long-Term Securities	These are securities that have a holding period of more than one year. The long term status is applied one year and one day from the date of purchase.
Lot	This is information on a purchase of a security, in which the date, cost and number of shares can be distinguished from all other purchases of the identical security.
Lot Relief Method	To compute the adjusted basis of securities sold, the proper lot (or lots) of securities held by the investor must be determined. This process is often referred to as "lot relief."
Lot Relief Method (Average Cost Double Category)	All tax lots are aggregated into two categories: (1) short-term category and (2) long-term category. Securities are aggregated into the short- and long-term categories based on the securities holding period. The cost basis is averaged for the securities held within these two categories. This method is applicable only to DRPs and mutual funds.
Lot Relief Method (FIFO)	Tax lots with the oldest trade date will be disposed of (sold, transferred or exchanged) first.
Lot Relief Method (LIFO)	Tax lots with the earliest trade will be disposed of first.
Lot Relief Method (High Cost)	Highest unit cost is disposed of first, whether the tax lots are short-term or long-term. If short-term and long-term lots have the same unit cost, long-term lot(s) will be disposed first.

Lot Relief Method (High Cost LT)	Tax lots with the highest unit cost, producing a long-term gain or loss, are disposed of first. Short-term shares with the highest unit cost will be disposed of, if no long-term shares are identified.
Lot Relief Method (High Cost ST)	Tax lots with the highest unit cost, producing a short-term gain or loss, are disposed of first. Long-term shares with the highest unit cost will be disposed of, if no short-term shares are identified.
Lot Relief Method (Low Cost)	Tax lots with the lowest unit cost are disposed of first, whether the tax lots are short-term or long-term. If short-term and long-term lots have the same unit cost, the long-term lot(s) will be disposed of first.
Lot Relief Method (Low Cost LT)	Tax lots with the lowest unit cost, producing a long-term gain or loss, are disposed of first. Short-term shares with the lowest unit cost will be disposed of, if no long-term shares are identified.
Lot Relief Method (Minimize Short Term Gains)	This minimizes the tax impact on the account by taking losses first and gains last. See above for the order of which tax lots are disposed.
Lot Relief Method (Average Cost—mutual funds only)	This is the average cost per share for all tax lots of a security, even those no longer held by the taxpayer: • Upon disposition of mutual fund shares, the average cost basis per share is used. • Although the calculation is an average, the tax lots are disposed on an FIFO basis.
Lot Relief Method (Specific-ID)	The only cost basis allocation method, other than FIFO, which is permitted under IRS rules for all securities. The security owner can specifically select a particular lot for disposal before the sale or for transfer. Confirmation back to the security owner, from the financial organization, is required to verify that particular lot or lots were sold as instructed.
Noncovered Securities	These are securities purchased prior to the effective date (for stocks, January 1, 2011), whose cost basis is not required to be tracked by financial organizations.
Non-qualified Stated Interest	This value will be populated on OID contingent payment bonds that pay non-qualified stated interest. This value offsets any OID paid on the bond and functions as a cost basis reduction. This field will be included in the non-reportable section of the additional written statement.
Omnibus Account	This is an account established in the name of one financial organization, which combines the transactions of multiple investors for the convenience of the introducing firm.
Partial Sale	This represents a partial sale of a tax lot. See also sub-lot (see next page).
Pre-effective Securities (Grandfathered Securities)	These are securities that are purchased or acquired before the cost basis reporting effective date.
Private Sale	This is sales and transaction activity that occurs privately and without the use of a regulated exchange.
Privately Issued Securities	This refers to the issuance of securities, without the use of a regulated exchange (e.g., NYSE, Nasdaq, etc.).
Prorated Interest Payment	This value is the amount of qualified stated interest paid prorated on the tax lot level which may be potentially offset by bond premium. This value will be reported on Form 1099-INT in Box 1 for taxable bonds, Box 3 for government bonds, Box 8 for nontaxable bonds NOT subject to AMT and Box 9 for nontaxable bonds which ARE subject to AMT.
Purchase	This represents securities that are purchased or acquired.
Reclassification of Income	This refers to situations where income is initially classified as dividend income, but part or all is later determined to capital gain distributions or return of capital. Reclassifications often occur in January of the following calendar year.

Reportable Income	The value populated in this field represents the total market discount accrued from the acquisition through the time of sale or maturity. This accrual is tracked separately from the bond's cost basis since reporting is deferred until the time of sale or maturity. Reportable Income will offset the calculation of realized gain or loss. As default, this field will be populated when bonds purchased at a market discount are sold or matured provided that the investor does not elect to include market discount accruals in income annually. This value will be used to populate Form 1099-B Field 1G.
Restricted Shares	These are shares that are transferred to an account for the benefit of an employee or other person. Vesting or ownership of the shares is contingent on a future event and typically will not be vested until the occurrence of a specified event.
S Corporations (S-Corps)	This is a corporation that has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. In general, S corporations are limited to one class of stock, only U.S. citizens and residents may be shareholders. Partnerships and corporations may not be shareholders and they may have only 100 shareholders.
Sale	This represents securities that are sold.
Scrip Dividends	A scrip dividend is a scrip issue made in lieu of a cash dividend. Shareholders can choose whether to receive a cash dividend or shares.
Short Sale	This is selling a security that drives an account short and creates a borrow requirement, with the understanding that it must later be bought back and returned to the lending party.
Short-Term Securities	These are securities that have a holding period of one year or less.
Sub-Lot	Each tax lot is composed of multiple sub-lots. The sub-lots constitute portions of the total lot.
Transfers	This represents the transfer of securities from internal or external accounts. To the extent that securities are transferred to contra firms, the cost basis reporting information must be transferred within 15 days. See 15-day Rule on page 16.
Unused Amortization	This field displays the amount of the amortization that has occurred since the last paid coupon payment and it will reset to zero upon receipt of an interest payment. This field is not reported to the IRS until it is moved to the "YTD Reportable Income Adjustment" field upon receipt of an interest payment.
Wash Sale	This is where a security is disposed of at a loss and an identical security is purchased or acquired during the 30-day period before/after the sale. The loss is disallowed and is used to adjust the cost basis of the reacquired security.
Year-to-Date Reportable Income Adjustment	This field has a dual purpose, it will be used for both premium and discount purchases. Positive values report market discount accrual to be included in income annually (current inclusion). Negative values signify bond premium amortization interest income offsets. This field will only recognize bond premium amortization when an interest payment is received which may be offset. If an interest payment is not received, the bond premium amortization will remain in the unused amortization bucket described below. In unrealized gains and losses, this value will reset to zero after it is reported to the IRS at year end. Cost basis is adjusted for both current inclusion of market discount accruals and bond premium amortization. Therefore, this field will not offset unrealized nor realized gains and losses. If this field is populated with a positive value representing a discount bond electing current inclusion, the value displayed in this field at year end will be reported to the IRS on Form 1099-INT in Box 10. If the bond has OID, this value must be reported on Form 1099-OID Box 5. If this field is populated with a negative value representing premium bond amortization at year end, this value will be reported to the IRS on Form 1099-INT in Box 11.

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