

# A GUIDE TO COST BASIS TAX REPORTING CHANGES AND HOW THEY AFFECT YOU

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## An Introduction to the Legislation and New Forms

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# THE NEW COST BASIS LEGISLATION

The federal government put new tax reporting requirements into place as part of the Emergency Economic Stabilization Act of 2008. The purpose of the legislation was to make sure that investors accurately report gains and losses on securities when they file their taxes.

Ultimately, the changes are expected to simplify tax preparation for investors. As the legislation rolls out in phases from 2011 through 2013, Schwab has been working with your investment advisor to prepare.

This guide is designed to answer your questions about what these changes mean for you.

## What does the legislation require?

The regulations require Schwab and other broker-dealers to report the adjusted cost basis for taxable accounts to you and to the IRS.

The new reporting requirements apply to all covered securities and will be phased in over three years according to the schedule at right.

## What this means for you

If you buy a security in a taxable account, on or after the applicable dates above, it is considered a “covered” security and Schwab will report cost basis to you and to the IRS when sold.

Although the IRS requires that Schwab report cost basis only for covered securities, we’ve heard from advisors and clients like you that it would be helpful to receive gain/loss information for uncovered securities as well, because you still have to report this information to the IRS. Therefore, for “uncovered” securities—that is, any security acquired before the effective dates—Schwab will report the cost basis to you but not to the IRS.

Starting In late January 2012, Schwab will provide you with updated year-end tax reporting for 2011 via our revised Form 1099 Composite. The composite includes your Form 1099-B information (and information for any other 1099 forms applicable to you), as well as a new Year-End Summary section with year-end gain/loss data to make accurate tax reporting easier for you.

Implementation Phase	Covered Securities	Uncovered Securities
Equities*	Acquired on or after Jan. 1, 2011	Acquired prior to Jan. 1, 2011
Mutual funds, ETFs, DRIPs**	Acquired on or after Jan. 1, 2012	Acquired prior to Jan. 1, 2012
Fixed income, options, other securities***	Acquired on or after Jan. 1, 2013	Acquired prior to Jan. 1, 2013

### Broker vs. taxpayer responsibility:

**Covered securities:** Brokers will report cost basis to the IRS and taxpayers on Form 1099-B. Taxpayers will use Form 1099-B data in preparing their tax return filings for 2011 and following years.

**Uncovered securities:** Broker may supply cost basis information to the taxpayer. Taxpayer will report cost basis to the IRS.

\* Equities include corporate stock (other than stock in a regulated investment company [RIC] or stock acquired in connection with a dividend reinvestment plan [DRIP]). Internal Revenue Code section 6045(g)(3)(C)(i) provides that the applicable date is January 1, 2011.

\*\* For stock in a RIC (RIC stock) or stock acquired in connections with a DRIP (DRIP stock), section 6045(g)(3)(C)(ii) provides that the applicable date is January 1, 2012.

\*\*\* For any other specified securities, section 6045(g)(3)(C)(iii) provides that the applicable date is January 1, 2013, or a later date to be determined in the future. The reporting rules for options transactions apply only to options granted or acquired on or after January 1, 2013, as provided in section 6045(h)(3).

## COST BASIS DEFINED

*Adjusted cost basis* is used to determine the capital gains or losses of an investment for tax purposes. This is the new information you will see on your Form 1099-B and Year-End Summary.

*Cost basis* is the original purchase price you paid for a security, plus commissions and any other fees. The longer a stock or other asset is held, the more likely it is that the original purchase price will need to be adjusted to reflect changes over time.

*Adjusted cost basis*, then, is the original cost basis plus any adjustments due to wash sales, amortization and accretion, or corporate actions, such as capital returns, stock splits, and dividend payments.

Here's an example of an adjusted cost basis calculation and the impact it can have on your portfolio:

*You buy 100 shares of a stock for \$1,000. The first year you own the stock, the company pays \$100 in dividends, which you reinvest. The next year, you receive \$200 in dividends and capital-gains distributions, which you again reinvest. Because tax law considers these reinvested earnings as paid to you even though you didn't actually have the cash in hand, your adjusted cost basis when the stock is sold should be recorded at \$1,300 instead of the original purchase price of \$1,000.*

*Then you sell the stock for \$1,500. Your taxable gain is based on that adjusted cost basis, so it amounts to only \$200 (\$1,500-\$1,300). If you record the cost basis as \$1,000 and calculate the cost basis as \$500, you'll pay more taxes than you have to.<sup>1</sup>*

## COST BASIS METHODS

Calculating cost basis is complex and, as you can see from the above example, you want to make sure that your cost basis is calculated accurately so that you don't pay more taxes than you should.

You may want to talk to your advisor about choosing the right cost basis method that meets the needs of your unique situation.

When you or your advisor sells any of your holdings in a security, Schwab uses a default cost basis method to determine which shares to sell. Schwab's default method for all non-mutual fund securities (e.g., equities) is called FIFO, or First In First Out. For mutual funds Schwab's default method is average cost.

At right is a list of the various cost basis methods available at Schwab.

When your advisor sells securities for you, he or she may see a potential tax advantage by indicating specific lots to sell. This is an option for all shares sold, and you can identify these transactions on your trade confirmation.

Cost Basis Method	Definition
FIFO (First In First Out)	Shares acquired first are sold first.
LIFO (Last In First Out)	Shares acquired last are sold first.
High Cost	Shares with the highest cost are sold first.
Low Cost	Shares with the lowest cost are sold first.
Tax Lot Optimizer™	Lots are sold with the objective of taking losses first (short-term, then long-term) and gains last (long-term, then short-term).
Average Cost	Computed by dividing the total dollar amount invested in a fund position by the number of shares held. Shares are sold in FIFO order.

1. [www.investopedia.com/terms/c/costbasis.asp](http://www.investopedia.com/terms/c/costbasis.asp), s.v. "cost basis," accessed August 8, 2011.

# REPORTING YOUR COST BASIS

We've redesigned the Form 1099 Composite, which includes Form 1099-B and a Year-End Summary, to make tax preparation easier. Now all tax information is contained in one report—delivered at one time.

## Revised Form 1099-B

The revised Form 1099-B will now provide cost basis information for both covered and uncovered securities. The form includes five new areas:

- **Acquisition date** of any securities sold.
- **Adjusted cost basis** shows the original price paid for the securities sold and any adjustments due to wash sales, amortization, accretion, and corporate actions.
- **Disallowed wash sale losses** shows the amount of loss that has been disallowed when a wash sale transaction occurs.
- **Covered and uncovered securities** indicates whether the securities sold were not covered by the new legislation.
- **Holding period** indicates holding period of the securities as either short- or long-term.

Recipient's Name and Address		Payer's Name and Address		Date Prepared: January 11, 2012						
DANA JONES JOHN JONES C/O SAMPLE GLOBAL ENTERPRISE 3RD FLOOR, SUITE 1800 1234 MAIN STREET ANYTOWN, US 12345 Taxpayer ID Number: ***-**-0000 Account Number: 1111-9999		CHARLES SCHWAB & CO., INC. 211 MAIN STREET SAN FRANCISCO, CA 94105 Telephone No: (800) 435-4000 Federal ID Number: 94-1737782								
<b>Proceeds From Broker Transactions—2011</b>				<b>Form 1099-B</b>						
Department of the Treasury—Internal Revenue Service Copy B for Recipient (OMB No. 1545-0715)										
<b>COST BASIS METHOD: Mutual Funds: Average; All Other Investments: First In First Out (FIFO)</b>										
8-Type of gain or loss: Short-term										
9-Description	CUSIP Number	Quantity **	1a-Date of sale or exchange	1b-Date of acquisition	2-Sales price of stocks, bonds, etc. (less commissions and options premiums)	3-Cost or other basis	4-Federal income tax withheld	5-Wash sale loss disallowed	6-If this box is checked, boxes 1b, 3, 5 and 8 may be blank	
123 CORPORATION	00108XXXX	S	01/12/11	04/26/11	\$ 6,172.55	\$ 5,172.55	\$	500.00*	\$	0.00
		100.00								
123 CORPORATION	00108XXXX	S	08/22/11	12/26/11	\$ 24,690.20	\$ 14,690.20	\$	0.00	\$	6,000.00
		400.00								
<b>Security Subtotal</b>					<b>\$ 30,862.75</b>	<b>\$ 19,862.75</b>	<b>\$</b>	<b>0.00</b>	<b>\$</b>	<b>6,000.00</b>
MORTGAGE BACKED SECURITY	90000XXXX	R	01/02/11	03/25/11	\$ 1,215.67	\$ 215.67	X	\$	\$	0.00
		40,000.00								
<b>Security Subtotal</b>					<b>\$ 1,215.67</b>	<b>\$ 215.67</b>	<b>\$</b>	<b>0.00</b>	<b>\$</b>	<b>0.00</b>
<b>Total Short-Term Sales Price from Broker Transaction</b>					<b>\$ 30,078.42</b>	<b>\$ 20,079.42</b>				

# Revised Year-End Summary

Your Year-End Summary is now included in a section of the 1099 Composite and covers some new information:

**Data is now organized by IRS 1040 schedules** (e.g., Schedules D, A, and B) for easier reference.

**A table of contents** has been added to help you quickly locate relevant information.

The new **Realized Gain/Loss Summary** section incorporates information from the previous Year-End Gain/Loss Report (YEGLR) and provides a consolidated

view of gains and losses, cost basis, and wash sale data for easy tax preparation. This means the Year-End Gain/Loss Report will no longer be sent to you separately.

**Summary of fees and expenses** indicates advisor or advice fees that are debited from your account and shows the margin interest paid.

Also new is **year-to-date amortization and accretion** information for certain fixed income securities, which may help you to adjust income on your Schedule B.

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Schwab One® Account of  
**DANA JONES**

Account Number  
**1111-9999**

TAX YEAR 2011  
YEAR-END SUMMARY

Date Prepared: January 11, 2012

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Schwab One® Account of  
**DANA JONES**

Account Number  
**1111-9999**

TAX YEAR 2011  
YEAR-END SUMMARY

Date Prepared: January 11, 2012

REALIZED GAIN OR (LOSS)

The information in the following sections include all your realized gain or (loss) transactions during the tax year. They may be helpful for, but not limited to, Schedule D. Please consult with your tax advisor or financial advisor regarding specific questions.

**Short-Term Realized Gain or (Loss)** COST BASIS METHOD: Mutual Funds: Average; All Other In

Description	CUSIP Number	Quantity/Par	Date of Acquisition	Date of Sale	Total Proceeds	Cost Basis	Realized Gain or (Loss)
123 CORPORATION	00108XXXX	100.00	01/21/11	04/26/11	\$ 6,172.55	\$ 5,172.55	\$ 1,000.00
123 CORPORATION	00108XXXX	400.00	08/22/11	12/26/11	\$ 24,690.20	\$ 14,690.20	\$ 10,000.00
<b>Security Subtotal</b>					<b>\$ 30,862.75</b>	<b>\$ 19,862.75</b>	<b>\$ 11,000.00</b>
CALL ANY OLD CORP	XXXXXXXXXXA	10.00	02/21/11	03/21/11	\$ 0.00	\$ 1,030.50	\$ (1,030.50)
<b>Security Subtotal</b>					<b>\$ 0.00</b>	<b>\$ 1,030.50</b>	<b>\$ (1,030.50)</b>
MORTGAGE BACKED SECURITY	9000XXXXX	4000.00	01/02/11	03/25/11	\$ 1,215.67	\$ 215.67	\$ 1,000.00
<b>Security Subtotal</b>					<b>\$ 1,215.67</b>	<b>\$ 215.67</b>	<b>\$ 1,000.00</b>
<b>Total Short-Term</b>					<b>\$ 32,078.42</b>	<b>\$ 21,108.92</b>	<b>\$ 10,969.50</b>

First In First Out (FIFO)

Realized Gain or (Loss)
\$ 500.00
\$ 10,000.00
\$ 10,500.00
\$ (1,030.50)
<b>\$ (1,030.50)</b>

**Long-Term Realized Gain or (Loss)** COST BASIS METHOD: Mutual Funds: Average; All Other In

Description	CUSIP Number	Quantity/Par	Date of Acquisition	Date of Sale	Total Proceeds	Cost Basis Adjusted	Realized Gain or (Loss)
ANY MORTGAGE	12345XXXX	240000.00	11/30/07	11/07/11	\$ 21,500.00	\$ 22,000.00	\$ (500.00)
					\$	\$ 23,000.00	\$ 1,000.00
<b>Security Subtotal</b>					<b>\$ 21,500.00</b>	<b>\$ 22,000.00</b>	<b>\$ (500.00)</b>
					\$	\$ 23,000.00	<b>\$ 1,000.00</b>
SAMPLE COMPANY	65332XXXX	400.00	--	08/17/11	\$ 338.52	--	\$ 338.52
<b>Security Subtotal</b>					<b>\$ 338.52</b>	<b>--</b>	<b>\$ 338.52</b>
SAMPLE NATIONAL	58064XXXX	50.00	06/30/08	06/09/11	\$ (0.03)	\$ 2,250.00	\$ (2,249.97)
<b>Security Subtotal</b>					<b>\$ (0.03)</b>	<b>\$ 2,250.00</b>	<b>\$ (2,249.97)</b>

Please see the "Endnotes for Your Realized Gain or (Loss)" for an explanation of the codes and symbols in this Realized Gain or (Loss) section.

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## FORMS INCLUDED IN THE 1099 COMPOSITE

Your 1099 Composite could include several tax forms to report various information about your gains and losses.

<b>Form 1099-DIV: Dividends and Distributions</b>	Reports any dividend amounts earned on stocks and mutual funds in your Schwab account(s), including capital gains distributions.
<b>Form 1099-INT: Interest Income</b>	Reports any interest paid to your Schwab account(s).
<b>Form 1099-MISC: Miscellaneous Income</b>	Reports any royalty and substitute payments in lieu of dividends and interest paid to your Schwab account(s). You could also receive a separate Form 1099-MISC that reports "Other Income."
<b>Form 1099-OID: Original Issue Discount</b>	Reports any Original Issue Discounts (OIDs) accrued for the current year. The amount is based on the excess of the stated redemption price (at maturity) and the original issue (not purchase) price of the debt instrument, including bonds or notes that have a term of more than one year. This form also reports taxable income earned on securities with income taxable on accrual basis.
<b>Form 1099-B: Gross Proceeds from Broker and Barter Exchange Transactions</b>	Reports any proceeds from the sale of assets in your Schwab account(s), including tenders, redemptions, and taxable corporate reorganizations. Commissions have been deducted, and the reported proceeds reflect the trade date and net amount paid. <b>NEW for 2011:</b> includes acquisition date, wash sale disallowed loss, covered and uncovered status, and holding period.
<b>Year-End Summary (Realized Gain, Summary of Fees and Expenses, Amortization, and Accretion for Fixed Income) <b>NEW for 2011</b></b>	Provides concise investment activity information that may be useful as you complete your tax return.
<b>Realized Gain/Loss Summary</b>	Incorporates Information from the Year-End Gain/Loss Report into the Realized Gain/Loss section of the Year-End Summary and provides a consolidated view of gains and losses, cost basis, and wash sale data for easier tax preparation.
<b>Summary of Fees &amp; Expenses</b>	Reports advisor or advice fees that are debited from a client's account and details margin interest paid.
<b>Amortization and Accretion Information</b>	Provides a year-to-date amortization or accretion for certain fixed income securities, which may help to adjust income on Schedule B.

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## GLOSSARY

In addition to the terms explained in this guide, you may find the following definitions helpful in understanding cost basis.

**Accretion**—The difference between the price of a bond bought at a discount (below par) and its par value. When an investor buys a security in the secondary market at a discount (if the security was issued at or near 100), the purchase price is adjusted upward to 100 over the remaining life of the security until it reaches par on its maturity date.

**Adjusted cost basis**—The original price of a security plus commissions, fees, and any adjustments associated with wash sales and resulting from corporate actions. Cost basis is used to determine capital gains and capital losses of an investment for tax purposes.

**Average cost basis**—An IRS-approved method to determine the cost of mutual fund shares at time of sale; it may be selected for ETFs and DRIPs as well. Schwab uses the Single Category Average Cost method as the default method for mutual funds. This method divides the total dollar amount invested in a particular fund position by the number of shares held before the trade date. Reinvested dividends are actual fund purchases and are included in your cost basis. Based on this cost, you can determine whether a sell represents a gain or loss for tax purposes.

**Covered securities**—Securities acquired on or after the applicable dates outlined by the legislation. For example, if you purchased stock on or after January 1, 2011, those shares are considered to be covered securities.

**Gifted securities**—The new requirements dictate that, starting in 2011, any transfer between different owners must have cost basis reported in the new account and the asset has to be "flagged" as a gift, potentially impacting short-term versus long-term gain/loss reporting. If, at the time of the gift, the shares have an unrealized loss, special gift accounting rules must be considered when the gift recipient ultimately disposes of the shares, limiting the loss that may be claimed.

**Holding period**—The holding period is the number of days that a security is held, from the date of acquisition to the current or sale date.

The sale of a security is long-term if it has been held for more than one year and is taxed at capital gains rates. It is short-term if the security is held for one year or less and is taxed at your personal tax rate.

To compute the holding period of an asset, begin counting on the day after the asset was purchased, and stop counting on the trade date of the sale.

*Long-term:* If a shareholder holds the position for more than one year, a long-term gain or loss is realized. For example, if a shareholder purchased a security on April 1, 2010, and sold it on April 2, 2012, this is a long-term gain or loss.

*Short-term:* If a shareholder holds the position for one year or less, a short-term gain or loss is realized. For example, if a shareholder purchased a security on April 1, 2010, and sold it on April 1, 2011, this is a short-term gain or loss.

**Inheritance**—The new requirements indicate that, starting in 2011, any inherited covered security must have basis reported in the new account and the asset has to be "flagged" as inherited. If shares are acquired through an inheritance, Schwab will step up the basis to the fair market value on the date of death unless we are notified by the executor that the alternate date of death should be used. Inherited shares are always treated as long-term holdings.

**Lot (or tax lot)**—A position of any share quantity acquired on a specific date at a specific cost per share. One or more lots make up the position held in a security in the account. For example, if a client purchases 200 shares of XYZ in a single purchase, then the position is treated as a single lot for purposes of calculating gains and losses. If the client purchased 100 shares on two different occasions at different prices, the position is treated as two separate lots for calculating gains and losses.

**Option exercise or assignment**—Schwab adjusts the proceeds on the sale of an underlying equity if an option is exercised or assigned. (This is not required by legislation until 2013, but we are permitted to do it now.)

**Realized gain/loss (RGL)**—Actual gain or loss resulting from a closing transaction (sale or other reportable event), based upon the proceeds of the sale of securities.

**Settlement date** —The date an executed securities transaction must be settled (or completed) by purchasing or delivering a sold asset usually three business days after the trade was executed (T+3) or one day for mutual funds, options, and government securities.

**Short sales**—When selling a security before you actually own it, the new legislation requires that these short sales now be reported in the year they are covered, not in the year they are opened.

**Short-term versus long-term gains**—Tax rates for short-term gain (securities held for one year or less) are the same as your personal income tax rate. Long-term gain (securities held for more than one year) is subject to capital gains tax rates, which for many taxpayers are lower.

**Tax loss harvesting** —Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

For many investors, tax gain/loss harvesting is the single most important tool for reducing taxes now and in the future. If properly applied, it can reduce clients' taxes and help them diversify their portfolios in ways they may not have considered. Although it can't restore losses, it can certainly minimize the taxable liability. For example, a loss in the value of Security A could be sold to offset the increase in value of Security B, thus eliminating the capital gain tax liability of Security B.

**Transfer**—Movement of a security or securities from one custodian to another.

**Uncovered securities**—Securities acquired before the applicable dates outlined by the legislation. For example, if you hold stock that you purchased before January 1, 2011, those shares are considered uncovered.

**Unrealized gain/loss**—Gain or loss that has not been sold or "realized." Refers to the potential gain or loss based upon current market prices.

**Versus purchase**—A method of identifying specific shares (open lots) of securities to be sold for gain/loss reporting purposes.

**Wash sale rule** —This rule prohibits a taxpayer from claiming a loss on the sale of an investment if that identical investment was purchased within 30 days before or after the sale date. The intent of the IRS is to prevent a taxpayer from deducting a loss on his or her tax return when that person's financial position remains the same after the loss. Although the shareholder is not allowed to claim the loss on a wash sale, the disallowed amount is added to the cost of the repurchased security, enabling the shareholder to recognize the loss when the security is finally sold.

This rule applies only to losses. Gains must be reported even if the same shares are purchased within 30 days of the sale.

A wash sale generates two adjustments:

- All or a portion of the loss must be deferred and added back to the basis.
- The holding period of the purchased shares must be changed to account for the deferral.

As a result of the legislation, Schwab will report wash sales with identical CUSIP numbers within the same account to the IRS, but clients and their tax advisors still need to monitor and compute wash sales that occur across multiple accounts or brokers or substantially similar securities.

For informational purposes only. The information is not intended to provide specific financial, tax, compliance, or legal advice. You should consult professionals in these fields to address your specific circumstance.

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