

# Understanding Cost Basis

Your guide to understanding  
how it works





The sale or exchange of securities (stocks, bonds, and mutual funds) may create a taxable capital gain or allowable capital loss reportable to the IRS, depending on the cost basis of those securities. There are a number of IRS-approved methods for calculating cost basis, depending on the particular type of security, and each one can result in a different tax liability.

National Financial Services LLC (NFS) created this guide to give you a high-level overview of the concept of cost basis, and to help you work more effectively with your investment representative to determine which method may be best for your particular situation. As you may know, NFS has an agreement with your broker/dealer in which NFS provides trade execution clearing and other related services for your account.

## What is cost basis and why is it important?

The cost basis of a security is, in most cases, the original price you paid for that security adjusted for certain transactions, such as reinvested dividends, sales charges, stock splits, and additional purchases. Each of these may raise or lower the original price of your security and result in an adjusted “cost basis.” This adjusted cost is used to determine the amount of profit or loss you realize on the disposition of those securities.

For most securities there are at least two different methods for calculating cost basis. For mutual funds there are four. Each method can result in a different tax liability, so the selection of the appropriate method is important. Your investment representative or tax advisor can help you make this determination. NFS reports sales, redemptions, and exchanges on your monthly statement; at the end of the year, they report all of this information on Form 1099-B.

## What are the different cost basis methods?

For individual securities, such as stocks and bonds, there are two IRS-approved methods for determining cost basis — first-in first-out (FIFO) and specific shares identification (also known as tax lot). For mutual funds, there are four approved methods: first-in first-out, average cost–single category, specific shares identification, and average cost–double category.

A brief overview of each follows:

### **First-in first-out (FIFO)**

*Use for mutual funds and individual securities*

With the FIFO method, it is assumed that the oldest shares held are the first to be sold, resulting in shares being sold in chronological order of acquisition.

**Considerations:** The IRS assumes you are using the FIFO method if you do not specify another cost basis calculation when you file your income tax return. In addition, depending on the length of time you have held your securities and their current value, this method could result in the realization of a larger capital gain than may be the case if you elected to use the specific shares identification method.

### **Average cost—single category**

*Use for mutual funds only*

With this method, you use the average cost per share for all shares of the same mutual fund owned at the time of disposition, regardless of how long you owned them, as your basis for determining capital gains or losses on disposition. To determine the average cost, you simply add up the costs for the various purchases you make, including reinvested dividends and other reinvested distributions, and divide that number by the total number of shares you own. Subtracting this average cost per share from the amount realized on the sale of your mutual fund

shares will result in a capital gain or loss.

**Considerations:** If you did not purchase all of the shares at one time, gains or losses are classified as long term or short term by assuming that you sold the oldest shares first. If you choose this method, you must state that you are using the average cost—single category method on your income tax return by writing “AVGB” in the appropriate section of Schedule D. In addition, you should be aware that you may not change to another cost basis method for future sales for the same mutual fund without IRS approval. You may, however, use a different method for a different mutual fund.

### **Specific shares identification**

*Use for individual securities and mutual funds*

This method of determining cost basis allows you to identify which shares you are selling and gives you the most control over the amount of the gain or loss.

**Considerations:** You must specifically identify the shares, or “lot,” you are selling or exchanging at the time of, and prior to completing, the transaction. To do this, you must notify your broker or mutual fund company that you are conducting a tax lot sale, specify the number of



shares you are selling, the original purchase price, and the date they were purchased. For individual securities, your broker's original confirmation statement should have a trade reference number that can be used to identify the particular shares you are selling. For mutual fund shares, you will have to refer to your yearly statements. It is highly recommended that you retain a copy of the request for your records in the event the IRS questions your use of this method.

### **Average cost—double category**

*Use for mutual funds only*

In this particular method, all shares of a fund are divided into two categories: short term and long term. Shares held one year or less are considered short term. Shares held longer than one year are long term. At the time of the sale, an average cost is computed for each category.

**Considerations:** To use this method, you must tell your broker or the mutual fund company from which category the shares are to be sold or exchanged. Your agent must confirm in writing your specification. If you do not specify the category or do not receive written confirmation from your agent, the IRS requires you to charge the shares sold against the long-term category and then charge any remaining shares against the short-term category.

### **Additional considerations**

The hypothetical scenario we used to illustrate the various cost basis methods is fairly simple. You may find other factors that you will need to consider in calculating your cost basis. Here are some examples:

- Reinvested dividends
- Fixed-income securities:
  - Accrued interest
  - Original interest discount (OID securities)
- Mutual fund sales charges
- Brokerage commissions
- Wash sales
- Inheritances or gifts
- Mergers and acquisitions
- Worthless securities
- Other mutual fund issues:
  - Return of capital
  - Tax-exempt dividends
  - Merged funds
  - Deferred sales charges and trading fees

### **Reinvested dividends**

Each time you reinvest dividends or capital gain distributions, you are purchasing additional shares that add to the cost basis of your stock or mutual fund.

Cost basis for shares purchased by reinvestment is equal to the total amount of the dividend or capital gain received. Be sure to take this additional amount into account when calculating cost basis.



If you receive shares of stock at a discount, your basis is the full fair market value of the stock on the dividend payment date. You must include the amount of the discount in your income for the year.

### **Fixed-income securities**

You may want to adjust basis in situations that may require a yearly adjustment such as amortization of a premium you paid or discount you received when purchasing a bond. You may wish to consult a tax advisor for assistance.

### **Accrued interest**

When selling a bond on a date between scheduled interest payments, the buyer must pay the seller for the interest accumulated (or accrued) during the additional days that the seller has still owned the bond. On the next interest payment date, the buyer will receive the full interest payment for the entire period, including the accrued interest that he or she has paid the seller as part of the purchase price.

### **Original issue discount (OID) securities**

The IRS requires taxpayers to pay income tax each year on a prorated portion of the interest that holders of certain bonds, such as zero-coupon bonds, will not actually receive before the bond matures. This “phantom” interest represents the yearly amount you would be due were your bond a normal interest-paying bond. NFS calculates this “phantom” OID interest, and reports it to you and to the IRS on Form 1099-OID. If you have received OID interest, in addition to reporting it on your tax return, you should also add it to the basis of your bond (this is called “stepping up the basis”).

### **Mutual fund sales charges**

If you buy a fund that has a sales charge, or load, include the sales charge as part of your cost basis. For example, if you invest \$2,500 in a fund with a 3% load, you pay a sales charge of \$75 and \$2,425 (97% of \$2,500) will be invested in your fund. Your cost basis is your entire \$2,500 initial investment including the sales charge.

Special considerations apply if you purchase a loaded fund, redeem the shares within 90 days of the purchase date, and subsequently purchase new shares with a load or fee that was reduced due to the prior purchase and redemption. Consult your tax advisor or refer to IRS Publication 564, *Mutual Fund Distributions*, for further information.

## Brokerage commissions

Commission costs may be reported on trade confirms.

## Wash sales

A wash sale occurs if you sell shares at a loss and buy additional shares in the same security 30 days before or after the sale. You cannot claim the loss on your tax return until you sell the additional shares. The IRS considers the additional shares as having “washed” your loss. For instance, if you made a dividend reinvestment on May 29 and then made an exchange redemption that resulted in a loss on June 12, some or all of the loss from your redemption would be considered a wash sale. Although you cannot take the loss on the original shares, the IRS allows you to add the loss to the basis of the additional shares you purchased. When you sell the additional shares in the future, your total gain or loss will reflect the deferred loss from the sale of those original shares.

If you own shares of the same fund in more than one account, the combined activities of the accounts could result in a wash sale.

## Inheritances or gifts

The cost basis of inherited shares is generally the value of the shares on the date that the decedent passed away. If the decedent’s estate filed a federal estate tax return (Form 706), you should check

the estate tax return to verify the cost basis of your inherited shares.

If you received shares as a gift, you must consider not only the value of the shares on the date of the gift and the donor’s cost basis, but also your sale price, to determine your gain or loss. Additional rules may apply. Consult your tax advisor before determining your gain or loss.

## Mergers and acquisitions

Some corporate mergers are considered taxable events for shareholders. Adjust the cost basis of your newly acquired shares according to the guidelines provided by the acquiring company, or from other sources, and report gains or losses when appropriate.

## Worthless securities

According to the IRS, stocks, stock rights, and bonds that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long term or short term.

## Other mutual fund issues

### Return of capital

A return of capital occurs when a fund’s distributions exceed its earnings in a fiscal year. Distributions are usually not taxable if they exceed taxable income. Taxable and nontaxable distributions are reported on Form 1099-DIV.

When distributions exceed earnings, your total cost basis is reduced by the amount of nontaxable distributions. Use your adjusted cost basis to calculate the gain or loss realized when redeeming shares. If return of capital exceeds cost basis, the excess is treated as capital gain income.

### **Tax-exempt dividends**

If you receive a tax-exempt dividend on your shares and sell the shares at a loss after holding them for six months or less, you may not claim the loss except to the extent that it exceeds the amount of the tax-exempt dividend received on the shares sold.

### **Merged funds**

Several mutual funds have merged in recent years. If you owned a fund that merged with another fund, your holding period and your total cost basis are unaffected by the merger. However, if due to the merger, the total number of shares you own has changed, then your cost basis per share will also have changed.

Your new cost basis per share is equal to your original cost basis divided by the new number of shares. For example, assume you owned 100 shares with a cost basis of \$2,000, or \$20 per share, before the merger. As a result of the merger, the 100 shares are replaced with 200 shares of the new fund. After the merger, the new cost basis per share would be \$2,000 divided by 200, or \$10 per share.

### **Deferred sales charges and trading fees**

In your calculations of gains or losses, include any deferred sales charges or transaction fees that you have paid. You may reconcile the charges in one of two ways: by subtracting the charges from your proceeds or by adding the charges to your cost basis. The method you should use is determined by the way in which NFS reports sale proceeds on Form 1099-B. The sale proceeds you report on your tax return should match the sale proceeds NFS reports on Form 1099-B. In brokerage accounts, NFS reports net proceeds; thus the deferred sales charges and transaction fees are subtracted from your proceeds. In mutual fund accounts, NFS reports gross proceeds. In this case, the deferred sales charges and transaction fees are added to your cost basis. For a given transaction, your gain or loss would be the same with either approach. Check to see that your Form 1099-B information and your tax return information match in order to avoid any reporting discrepancies.

### **For more Information**

The methods discussed in this guide should only be used as a starting point for understanding cost basis. Additional cost basis information may be found on your account statement.

NFS and its correspondents do not provide tax or legal advice. We encourage you to contact your



investment representative or tax advisor for specific questions regarding which cost basis method may be most appropriate for your particular situation and to ensure that you have all the information you need to determine the cost basis for your securities.

The IRS also publishes a number of informative booklets to assist taxpayers in understanding cost basis and capital gain calculations: IRS Publication 550, *Investment Income and Expenses*; IRS Publication 551, *Basis of Assets*; and IRS Publication 564, *Mutual Fund Distributions*. All of these publications are available free of charge from the IRS (800-TAX-FORM) or via download from their Web site, [www.irs.ustreas.gov](http://www.irs.ustreas.gov).

NFS-provided cost basis, associated realized and unrealized gain and loss, and holding-period information may not reflect all adjustments necessary for tax-reporting purposes. Taxpayers should verify cost basis, associated gain and loss, and holding-period information provided by NFS against their own records when calculating reportable gain or loss resulting from a sale. NFS does not report cost basis, associated gain and loss, and holding-period information to the IRS and is not responsible for the accuracy of such information taxpayers may be required to report to federal, state, and other taxing authorities.

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