Cost Basis for Securities

What You Need to Know

When you sell property, you will either create a taxable capital gain or a potentially tax-deductible capital loss. The gain or loss is determined by comparing the amount you realize from the sale and the adjusted cost basis of the property. While calculating the amount realized is relatively simple (it is the sales price less expenses of the sale, such as commissions or purchase costs), calculating the adjusted cost basis can be much more challenging, depending on what type of property you sell and how you acquired it in the first place.

The rules for determining the adjusted basis of stocks, bonds, mutual funds and other securities are complex. This article will help to explain some of them in detail. Of course, when in doubt, check with your tax professional for guidance on your particular situation.

Purchased Securities

When you purchase a security, your cost basis is typically the amount you pay for the security, including any commissions or other purchase costs. For example, if you purchase 100 shares of Company A stock for $10 a share and pay a $60 commission on the purchase, your cost basis for the shares is $1,060 (100 shares times $10 per share, plus the $60 commission). Your cost basis per share of Company A stock is $10.60 ($1,060 divided by 100 shares).

If you participate in a dividend reinvestment program with Company A, you agree to reinvest all cash dividends that Company A pays you into more Company A stock rather than have them paid to you in cash. Each time a dividend is reinvested, the cost basis for the newly acquired shares of Company A stock will be equal to the amount of the cash dividend that was paid to purchase those additional shares. Using the information from the example above, assume you own 100 shares of Company A stock with a cost basis of $1,060, and you participate in the dividend reinvestment program. If Company A pays a dividend of $2 per share, your cash dividend is $2 times 100 shares, or $200. If you reinvest that dividend in new shares and the price is $20 per share, you will receive 10 new shares of Company A stock with a cost basis of $20 per share. The reinvestment of the dividend in the new shares does not affect the cost basis of your original 100 shares ($1,060 or $10.60 per share). You now own two separate “cost lots” of Company A shares.

Keep in mind that if you participate in a dividend reinvestment program, the cash dividends that you reinvest are still dividend income to you at the time they are paid and reinvested and thus, any corresponding income tax liability will be due at that time.

Cost Basis Methods

If your account is at Benjamin F. Edwards and you own multiple cost lots of a security and sell less than your entire position in that security, your adjusted basis in the security will be determined using the first-in, first-out (FIFO) method, unless you instruct otherwise. That is, when you sell shares, it is assumed that you sell the shares have owned for the longest period of time. Besides FIFO, you may designate the following other cost basis methods either at the account, trade or security level:

- Min Tax
- High Cost
- High Cost Long Term
- High Cost Short Term
- Last In First Out
- Low Cost
- Low Cost Long Term
- Low Cost Short Term

If you would prefer to sell specific shares, you may do so as long as you identify which shares you want to sell and communicate that information to your financial advisor at the time of the sale (prior to settlement date). This method is known as the specific identification method.

A third method of computing cost basis is average cost per share, which is available if you own mutual fund shares or shares of stock acquired through a dividend reinvestment program. For further guidance and to determine if you are eligible to use the average cost per share method, please consult your tax professional.

Securities Received as Gifts

If you've received a gift of securities from another individual, your cost basis is determined based on the donor's adjusted cost basis at the time of the gift and the fair market value of the securities on the date of the gift. You will assume the same short-term or long-term holding period as the donor.

If the fair market value on the date of the gift is greater than the donor's cost basis for the securities (in other words, the securities have appreciated in value since the donor purchased them), then your cost basis will be the same as the donor's.

However, if the fair market value of the securities on the date of the gift is less than the donor's cost basis for them (in other words, the securities have depreciated in value since the donor purchased them), then your cost basis is not determined until you sell the securities. In that case, if you sell the securities for less than the fair market value on the date you received them as a gift, your cost basis is the value on the date of the gift, resulting in a capital loss for any depreciation that occurred subsequent to you receiving the securities.

Conversely, if you sell the securities for more than the donor's original cost basis, your cost basis is the donor's original cost basis, resulting in a capital gain for any appreciation that occurs over and above the donor's original cost basis. If you sell the securities for an amount that is in between the donor's original cost basis and the fair market value on the date you received the gift, your cost basis is equal to the selling price.

Example Assume your uncle purchased Company B stock for $10 a share and then gives the shares to you when they are worth $5 a share. Because the fair market value on the date of the gift is less than your uncle's cost basis, your cost basis is not determined until you sell the shares. If you sell them for $12 a share, your cost basis is $10 a share. If you sell them for $2 a share, your cost basis is $5 a share. And if you sell them for $7 a share, your cost basis is $7.

DATE OF GIFT		YOUR SELLING PRICE	YOUR COST BASIS	GAIN OR (LOSS)
		$12	$10	$2
DONOR'S COST BASIS	$10			
		$7	$7	$0
FAIR MARKET VALUE	$5			
		$2	$5	($3)

As you can see, when a donor gifts depreciated securities, the donor's loss for the period that he or she owned the securities is forfeited. Therefore, if the securities have depreciated at the time the donor decides to make the gift, it would be more advantageous for the donor to sell the securities, recognize the capital loss himself, and then gift the cash proceeds from the sale to you.

Note that if the shares are appreciated on the date of the gift and then subsequently depreciate (after you received them), your cost basis is still the same as the donor's. It's only when the securities are depreciated on the date of the gift that your selling price will factor into the determination of your cost basis.

Inherited Securities

If you have inherited securities, your cost basis is usually the fair market value of the securities on the date of the individual's death. The adjustment of cost basis to fair market value on the date of death is called a "step-up." However, if the fair market value is less than the decedent's cost basis on date of death, the adjustment to cost basis is "stepped down" to fair market value as well.

In some cases, your cost basis will be the fair market value on the alternate valuation date if the personal representative for the estate has elected to use the alternate valuation date, which is six months after the date of death and applies to all assets in the estate. Alternate valuation is only available if there is an estate tax due and the estate tax amount is less as a result of using the alternate valuation date (i.e., the total estate value has declined). When in doubt, check with the personal representative of the estate to determine if the alternate valuation method has been elected for the estate.

Note that special rules apply to property acquired from a decedent who died in 2010. If you inherited property from someone who died in 2010, please consult your tax professional for guidance.

Also note that any deferred income property such as IRAs, qualified retirement accounts, deferred annuities or savings bonds, will not receive a step-up in cost basis at death. The decedent's cost basis will carry over to the beneficiary. Therefore, the beneficiary will be subject to income tax on any income at the time distributions are made.

Cost Basis of Inherited Assets*

OWNERSHIP	COST BASIS
INDIVIDUAL ASSETS	FULL STEP UP OR STEP DOWN
JOINT & SURVIVOR WITHOUT SPOUSE	STEP UP OR STEP DOWN ON DECEASED CONTRIBUTED PORTION
JOINT & SURVIVOR WITH U.S. CITIZEN SPOUSE	HALF STEP UP OR STEP DOWN
REVOCABLE LIVING TRUST	FULL STEP UP OR STEP DOWN (NOT INCLUDING JOINT TRUSTS)
TRANSER ON DEATH (TOD)	FULL STEP UP OR STEP DOWN (SEE JOINT OWNER INFORMATION ABOVE IF JOINT TOD)
COMMUNITY PROPERTY	FULL STEP UP ON BOTH HALVES

* Consult a tax advisor if assets were inherited due to death in 2010 or if joint account was created prior to 1977.

Adjustments to Cost Basis

Once you acquire a security, it will usually retain the same cost basis over the time you hold it. However, a few events may require an adjustment to cost basis while you hold the security.

Stock Splits/Stock Dividends A company may declare a stock split to lower the price per share of its stock. If you own a stock that splits, you will need to determine how many shares you own after the split and then allocate your total cost basis among the new number of shares.

For example, assume you own 100 shares of Company C stock and your cost basis is $10 a share (or $1,000 total). Company C declares a 2-for-1 stock split. That means that for every 1 share of stock you own, you now own 2 shares. In other words, you now own 200 shares, but your total cost basis is still $1,000. To determine your cost basis per share, you take the total cost basis of $1,000 and divide it among the 200 shares you now own. Your new cost basis per share is $5.

Sometimes companies will declare a stock dividend. This is another way for the company to lower the price per share and also conserve cash. If Company C above declares a 25% stock dividend rather than a stock split, you would receive 25 additional shares (25% times 100 shares owned). After the stock dividend, you would own 125 shares, and your cost basis per share would be $8 ($1,000 divided among 125 shares).

Return of Principal Distributions A company may distribute more than its current earnings and profits to investors. This excess distribution is designated as a return of principal. When this happens, it is a return of your original investment and is usually not taxable to you. However, a return of principal distribution is a reduction in your cost basis in the security (and may be taxable if it reduces the cost basis to below zero).

Examples of investments that may generate return of principal distributions are debt securities, unit investment trusts or limited partnerships. For guidance on how to adjust cost basis for return of principal distributions, please consult your tax professional.

Watch out for wash sale rules when selling securities at a loss

The wash sale rules state that you may not take a tax loss on the sale of a security if you have acquired (or entered into a contract or option to acquire) “substantially identical” securities 30 days before or 30 days after the date of the sale. Note that dividend reinvestment counts as a purchase.

If you trigger a wash sale, your original loss will be disallowed. However, you can add the loss to the cost basis of the new shares. So, when you sell those newly purchased shares at a later date, you will get the benefit of the loss at that time.

As you can see, determining your cost basis for various securities can be very complex. Recent cost basis reporting requirements by the Internal Revenue Service require transfer agents and brokers to report cost basis on tax reporting documents. You should review these documents to ensure that they are correct. Mistakes can be costly when it comes to your income taxes. Therefore, we recommend that you seek professional guidance on cost basis questions from your tax professional. ■