Improving Your Finances

The Error-Proof Portfolio: Give Due Care to Your Cost Basis Elections

By Christine Benz | 10-31-11 | 06:00 AM | E-mail Article

The arcane business of calculating your investments' cost basis is about to get a little easier, provided you have a full understanding of the choices you're about to make.

At the most basic level, cost basis is simply the amount you've paid for an asset. The difference between your cost basis and the price at which you sell that asset is used to determine the amount of capital gains tax you owe on the transaction. For stocks, bonds, and funds, your cost basis will be adjusted for any commissions you paid as well as stock splits (for individual stocks) and reinvested dividends and capital gains (for funds).

In the past, the onus was on taxpayers to track and report their cost basis to the IRS. While financial firms may have supplied their clients with varying levels of information about their purchase prices, they didn't have responsibility for conveying that information to tax authorities. But starting in 2012, mutual fund firms will be required to track cost basis of funds and report it to the IRS as well as to shareholders. Cost-basis tracking and reporting has gone into effect on a staggered basis: At the beginning of this year, brokerage firms began tracking cost basis for stocks, and similar rules for tracking cost basis for bonds, options, and other securities will go into effect at the beginning of 2013.

Only taxable accounts will be affected. Retirement accounts like IRAs and 401(k)s aren't subject to the new rules; money market funds, because they almost never have capital gains, will be unaffected, too. Moreover, the cost-basis requirements will only apply to shares acquired after the cost-basis rules went into effect--2011 for stocks, 2012 for mutual funds, and 2013 for almost everything else. For shares acquired prior to these dates, investors will be responsible for tracking and reporting cost basis on their own. (This article provides an overview of the new cost-basis rules.)

As part of the new rules, investors will also need to tell their financial firms what method the firms should use to calculate and report their cost basis in the future, and investors have already begun receiving cost-basis election forms from their providers. Bear in mind that the new rules allow for a fair amount of flexibility: Investors will be able to select different cost-basis methods for different accounts, and they'll be able to reverse their cost-basis elections before they redeem shares. (For example, they can switch from the FIFO method to specific share identification; switching into or out of the averaging method, however, is likely to require additional paperwork.)

Here's an overview of the key cost-basis options that mutual fund owners will see on these forms. (Holders of individual stocks will have a different set of options--usually specific share identification, FIFO, and LIFO; see below for details on what those mean.) Be sure to consult your tax or financial advisor for guidance on which method of cost-basis calculation is most advantageous in your particular situation.

Average Cost

What It Is: Most mutual fund companies use the average method as the default, so if you don't specify a preferred cost-basis calculation method, that's the treatment your shares will likely receive. They arrive at the average by adding all of your purchases together and dividing by the number of shares. Say, for example, you purchase 100 shares of a fund at $8 apiece, 50 more at $10, and 50 at $12 each. Your average basis is $9.50 (your $1,900 in total purchases divided by 200 shares). If the share price were to drop to $9 and you wanted to sell 100 shares, your tax loss would be $50 (your basis of $950 for 100 shares minus your $900 sale price).

Why You Would Choose It (Or Not): Averaging is the most straightforward method of calculating cost basis, which helps explain why it's the default option for most mutual fund companies. You won't have to stop and think about which shares of your fund you want to sell when. However, if you've purchased many separate lots of a fund over several years or will be selling your holdings piecemeal in the years ahead, averaging doesn't allow you to exert as much control over your tax situation as the other cost-basis methods do. Investors using this method may end up paying more in taxes than if they used one of the following two methods. Averaging isn't an option for holders of individual stocks.

Specific Share Identification

What It Is: The specific share identification method addresses the shortcoming of the averaging method by allowing you to specify which lots you sell, thereby reducing the drag of taxes. For example, say you purchased shares of a fund in the same lots outlined above: 100 shares at $8 each, 50 shares at $10 apiece, and 50 more at $12 per share. If the fund's NAV drops to $9, you could sell your $10 and $12 shares to realize the loss, but leave your $8 shares intact. In that situation, your taxable loss would be higher than what you'd obtain with the averaging method, and you in turn could use the loss to offset taxable capital gains or--in the absence of any capital gains---up to $3,000 in ordinary income. Your loss would be $200, consisting of $150 from the sale of your 50 $12 shares (your $600 basis less your $450 sale price) and $50 from the sale of your 50 $10 shares (your $500 basis minus your $450 sale price). On the flipside, the specific share identification method allows you to sell low-cost-basis shares in years when it's advantageous to do so--when you have offsetting losses in other accounts, for example, or if you expect to be in a low tax bracket in a given year.

Why You Would Choose It (Or Not): As the preceding examples illustrate, the specific share identification method gives you the most latitude to reduce the tax effects of your investments. In the past it was also the most paperwork-intensive and complex of all of the cost-basis methods, but it should be easier to employ now that fund companies and brokerage firms are tracking cost basis themselves.

Loss/Gain Utilization

What It Is: This is a subset of the specific share identification method where, in essence, you ask your mutual fund firm to calculate your cost basis according to a set of tax-efficient rules. The company or broker will automatically sell those securities in which you have losses, starting with short-term losses and then moving to long-term losses. If you have gains in a security, the company will give preference to those that you've held more than a year. The last securities to be sold will be those in which you have a gain and have held for less than one year, as those will generally be the most costly from a tax standpoint.

Why You Would Choose It (Or Not): On the surface, the loss/gain utilization method appears to offer the best of both worlds: the tax-minimization effects of specific share identification along with the hands-off simplicity of averaging. (Assuming all of the gains and losses in my example above were long-term, the loss/gain utilization method would result in exactly the same amount of loss as the specific share identification method, but the shareholder wouldn't have to get involved in the decision.)

However, there are a couple of caveats to bear in mind. First, not all providers offer the loss/gain utilization method at this time. And because this technique strives for tax efficiency in only the accounts you hold at a single firm, it doesn't take into account external factors as you could with specific share identification. For example, if you've realized large losses elsewhere in your portfolio, it may be advantageous to sell low-cost-basis shares first. This method, like averaging, is available for mutual funds only.

Other Methods

What They Are: Investors will also be able to choose from other methods for reporting cost basis, including First In First Out (FIFO), Last In First Out (LIFO), Highest In First Out (HIFO), and Lowest In First Out. FIFO assumes that the first shares you purchased are the first ones to be sold, whereas LIFO assumes the opposite. The HIFO method assumes the highest-cost-basis shares are sold first, whereas the Lowest In First Out method does the opposite.

Why You Would Choose Them (Or Not): Although situations may vary, both LIFO and HIFO methods will generally result lower tax bills than will FIFO or Lowest In, First Out, especially for securities that generally rise in price.

FIFO, meanwhile, can work in investors' favor if securities drop in price; the older securities may have higher cost bases than those more recently added. If, by chance, you hold an investment that you expect to drop in value over time--a bear fund, for example, that you hold for hedging purposes--the FIFO method might make sense

In general, however, all of these methods give you less control than you have with the specific share identification or loss/gain utilization methods. Again, this is an area where a tax specialist or financial advisor can coach you on making appropriate choices.

Christine Benz is Morningstar's director of personal finance and author of *30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances* and the *Morningstar Guide to Mutual Funds: 5-Star Strategies for Success*. Follow Christine on Twitter: @christine_benz and on Facebook.