

**Path to Investing From Your Perspective:**

## **UNDERSTANDING COST BASIS**

- 2** Understanding cost basis
- 3** Basics of cost basis
- 4** Cost basis & gifts
- 5** Step up in basis
- 6** Cost basis & reinvested assets
- 7** Keeping cost basis records

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## Understanding cost basis

At tax time, there's a pressing question you'll have to answer if you've sold investments in a taxable account during the previous year: What were your capital gains and losses? You'll either owe capital gains taxes on your profits from selling, be able to take a deduction for your losses, or use your losses to offset gains and reduce the tax that's due. However, calculating what you've gained or lost can be more complicated than you might think.

### What is cost basis?

Before you determine your profit or loss, you need to know your original cost basis. Your profit or loss depends on the difference between your cost basis and the price at which you sold your investment. In the normal scheme of things, your cost basis is your original purchase price, but sometimes you can make adjustments to that figure to make it larger. Other times, you need to do a little calculating or even some sleuthing to figure out the correct basis to use.

For instance, calculating basis may be more complicated if you've been buying shares in an individual stock or a mutual fund at different prices over time, such as through a dividend reinvestment program (DRIP). Calculating basis can also be complicated if your stock has split. Your basis may also be affected if the company or fund you've invested in has merged with another. And the rules are different if you're not the person who originally bought the investment — for example, if you received it as a gift, in a settlement, or as part of an inheritance.

### No basis for comparison

You don't have to keep track of the cost basis of investments you make in tax-deferred or tax-exempt accounts, including retirement savings plans and IRAs. That's because when you withdraw from those accounts you pay tax on all your earnings and on any tax-deductible contributions at your regular rate. The gains or losses since you purchased the investment aren't part of the calculation.

### Common errors

If you're confused about cost basis, you're not alone. The Government Accountability Office (GAO) estimates that 38% of taxpayers reported capital gains incorrectly on their 2001 tax returns. Half of those returns used the wrong cost basis.

**Path to Investing From Your Perspective:  
UNDERSTANDING COST BASIS**

## Basics of cost basis

To understand how you should calculate the cost basis of your investments, you should look first at how you acquired them.

### When you're the original buyer

If you bought the investment yourself, calculating cost basis means you need to determine what you paid. That includes:

- Market price, commissions, or sales charges
- Other transaction costs, such as transfer fees
- Certain taxes, such as sales and excise taxes

It's important to include all these items, because if you use a lower basis than you're entitled to, your gain will be more and your loss will be less. In either case, a lower basis is likely to increase your tax bill.

### Adjustments to basis

If you realize taxable income from stock dividends or mutual fund distributions, you may wonder if those amounts increase your cost basis. The answer is no, if you took them in cash. However, if you reinvested them, they become part of your total basis in that security because they are used to buy additional shares. But they don't affect the cost basis of the shares you already own.

On the other hand, if you increase your holdings of a stock without paying full market price for the additional shares — such as when your stock splits — this will lower your basis in the original shares, since the same total basis will be spread over a greater number of shares. Your basis is also affected if a company in which you own shares spins off a division as an independent entity and you receive shares in the new entity.

Investments in real estate are particularly sensitive to adjustments to cost basis, since money you spend to enhance the value of your property increases your basis. This can add up to a substantial amount over time and result in a corresponding reduction in your capital gain at the time you sell.

**Path to Investing From Your Perspective:  
UNDERSTANDING COST BASIS**

## Cost basis & gifts

There are different rules for calculating cost basis if you've received the investments from someone else.

### Gifts

As a general rule, if the investment is a gift, you use the original buyer's adjusted basis at the time of the gift as your cost basis. One big exception is if, at the time you were given the investment, its fair market value (FMV) — the price for which it would sell in the marketplace — was lower than the giver's basis.

If so, you'll follow different rules for calculating gains and losses. For gains, you'll still start with the giver's adjusted basis, but for losses you'll substitute the FMV at the time you acquired the investment.

If the investment comes from your spouse, whether as a gift or as part of a divorce settlement, you use your spouse's adjusted basis at the time of the transfer.

### No records?

The giver is required to provide documents that you can use to determine an investment's basis — such as copies of purchase confirmations and contact information for the brokerage firm that handled the purchase — but not all givers have those records. If your basis depends on the giver's adjusted basis but you can't find records that tell you what that was, the IRS sets your basis as zero. However, before you settle for zero, it's best to talk to a tax professional who might suggest other ways to reconstruct the giver's basis.

### None of the above?

There are other rules for investments received as payment for services, as part of a trade for other property, or as transfers that are part sale and part gift. You can find out more in IRS Publication 551, "Basis of Assets," available on the IRS Web site at [www.irs.gov](http://www.irs.gov) or by consulting with a tax adviser.

**Path to Investing From Your Perspective:  
UNDERSTANDING COST BASIS**

## Step up in basis

You may get a break with inherited investments due to a feature of the tax law known as step up in basis. A step up in basis for inherited assets means that you don't need to use the original owner's basis to calculate yours. Instead, your basis is stepped up to the fair market value (FMV) at the time the estate of the owner is valued.

If the previous owner held the asset for a long time, the step up can provide a sizable tax break. For example, if the deceased bought a stock years ago when it was selling for a dollar a share, and you inherit it when its market value is \$50 a share, you could sell it right away and record no capital gains at all. In contrast, if you had to use the basis of the deceased, you would owe capital gains taxes on profits of \$49 per share, a big difference.

### **Disappearing step?**

Current tax laws specify changes to the rules for step up in basis in 2010. But tax laws are subject to further legislation by Congress, so there's no way to know whether the changes will occur on schedule.

**Path to Investing From Your Perspective:  
UNDERSTANDING COST BASIS**

## Cost basis & reinvested assets

Reinvesting dividends or capital gains distributions makes calculating basis a little trickier. Every time you reinvest, you purchase shares at the current market price, which is likely to be different each time. Consider this problem: Suppose you bought 500 shares of a stock and enrolled in the company's dividend reinvestment plan (DRIP). You accumulate 100 more shares, giving you 600 shares in total. You decide to sell 300 shares. How do you figure out your cost basis?

For stock, one way to clear up the confusion is to specify which shares you want to sell. Note that you can't select shares to sell after the fact, only at the time you order the sale. For example, you could choose to sell the shares you bought at the highest prices. This would give you the highest possible cost basis and, if you'd owned the shares for more than a year, make you eligible for the long-term capital gains rate, which is always lower than your ordinary income tax rate.

However, if you don't specify the shares you wish to sell, the IRS applies the first in, first out rule: They assume you sell the shares you bought first. If the price has been rising, this tends to result in a lower cost basis and therefore greater capital gains.

One caution, though: Once you choose a method for selecting shares of a particular security, you must use the same method when you sell additional shares of that security.

### **Mutual funds**

If you've been acquiring shares in a mutual fund over time, you can use either of the methods described for stocks, or you can use an average price per share. This method applies only to mutual funds, not securities like stocks and bonds.

### **Bonds**

Bonds don't have dividend reinvestment programs (DRIPs), but you can buy more of the same bond on the secondary market, where prices fluctuate. If you've bought bonds at different prices and decide to sell some of your holding in a particular issue, you come up with your basis using the same rules as for stocks.

**Path to Investing From Your Perspective:  
UNDERSTANDING COST BASIS**

## Keeping cost basis records

Before you conclude that calculating your basis is impossibly convoluted, you should know that for the most part, it's often very easy to get the cost basis for an investment: You simply request it from the financial institution where you have your account.

However, you're not off the hook when it comes to keeping records for your investments. The fact is that your financial institution might not always be able to give you your cost basis. For example, if you've transferred or rolled over the investments from another financial institution, your current firm might not have your purchase records. Or you may have received the investments from someone else, as a gift, inheritance, or other transfer.

### Hanging on to your records

Normally, you should keep records for tax purposes for three years after you file your return, or two years after you pay the tax due, whichever is later. However, you'll need to keep records that establish basis indefinitely or at least as long as you hold the investment. Check with your tax professional for advice about how long to keep records after you sell an asset or give it away.

Records you should keep include:

- Buy and sell confirmations
- Notices of splits, spin-offs, and mergers
- Records of purchases
- Receipts for work that increases cost basis
- Proofs of payment
- Letters or other documents detailing transfers

### When in doubt

When calculating basis seems complicated, it may be time to visit your tax professional, who can help you sort through what you need to do to establish your basis and what records you should keep to make it easier in the future. You may also want to consider using money management software that includes tools for calculating cost basis.

### Check your tax returns

One way to reconstruct how much you've reinvested in a stock and therefore how much you should add to your basis is to check your tax returns. Automatically reinvested dividends that you never see as cash still show up on your 1099-DIV, and you report them as taxable income.