Keep Track of Your Investment Basis

Article Highlights:

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In taxes, there is a saying: "Those who keep records win." If you are an investor, you may have a variety of securities, including stocks, bonds, mutual funds, etc. When you sell those securities, naturally you want to minimize your gains or maximize your losses for tax purposes. Gain or loss is measured from your tax basis in the investment (asset), which makes it important to keep track of the basis in all your investments.

What is *Basis*? Generally, your basis in an investment begins with the price that was paid to purchase the investment. However, that will not be the case if the investment was acquired by gift or inheritance. For inherited assets, the basis generally begins with the FMV of the asset on the decedent's date of death or an alternative valuation date, if chosen by the executor of the estate. Assets acquired by gift actually have a basis for gain - the donor's basis - and a basis for loss - the fair market value of the asset on the date of the gift. When an asset is acquired through a division of property in a divorce, the asset retains the basis it had when it was owned jointly by the couple.

Basis is not a fixed value; it can change during the time the asset is owned and is adjusted by certain events. For an investment asset, these events include:

- Reinvested cash dividends,
- Stock splits and reverse splits,
- Stock dividends,
- Return of capital,
- Additional investments,
- Broker's commissions,
- Interest previously taken into income under an election under the accrued market discount rules,
- Interest taken into income under the original issue discount rules,
- Attorney fees,
- Acquisition costs,
- Depletion,
- Casualty losses, etc.

These events can increase or decrease the tax basis in the investment, which makes adequate recordkeeping so important.

Another issue associated with basis is when a portion of the investment is sold. Let's say 100 shares of a particular stock were purchased in 2011 at $10 a share and another 100 shares in 2013 at $20 a share. The investor plans on selling 100 shares of the stock at $30 a share. Using the general rule of "first in - first out," there would be a $20 per share gain. However, if the investor can identify each specific block of stock sold, such as the 100 share block bought in 2013, there would only be a $10 per share profit. This is known as the "specific identification" method.

The following is a discussion of the more commonly encountered basis adjustments where recordkeeping is essential:

- **Reinvested cash dividends** – Investors are frequently given the opportunity to reinvest their dividends instead of taking them in cash. By participating in these plans, they are actually purchasing additional sales with their taxable dividends. Unless records are kept, the investor can't prove how much he or she paid for the shares or establish the amount of gain that is subject to tax (or the amount of loss that can be deducted) when it is sold.
- **Stock dividends** – It is possible to receive both taxable and nontaxable stock dividends. Stock dividends that are taxable provide the investor with additional stock with a basis equal to the taxable stock dividend. If the dividends are nontaxable, the number of shares that are owned increases, but the basis remains unchanged. If the investor can associate the dividends with a specific block of stock, then the basis of that block can be adjusted accordingly. If not, the adjustment will apply to the entire holdings in that particular stock.
- **Return of capital** – A return of capital is a nontaxable return of a portion of the investment. Thus, a return of capital will reduce the investor's basis in security. Suppose an investor has 100 shares of XYZ Corporation that cost $1,000 ($10 per share), and the corporation distributes to him a $100 nontaxable return capital. His basis in the stock is reduced to $900 ($1,000 - $100) or $9.00 per share. If, over a period of time, the return of capital exceeds his basis in the investment, then the excess becomes taxable because he cannot have a negative basis.
- **Stock splits** – Stock splits can be confusing if they are not tracked as they occur. Let's assume that an investor owns 100 shares of XYZ Corporation for which he paid $2,000 ($20 a share). Later on, the corporation splits the stock 2 for 1. The result is that he now owns 200 shares, but his basis in each has been reduced to $10 per share (200 shares times $10 equals $2,000 – what was paid for the original shares). This generally occurs when the "per share value of stocks" becomes too high for small investors to purchase 100 share blocks. Also watch for reverse splits, which have the opposite effect.
- **Stock spin-off** – Occasionally, corporations will spin-off additional companies. The most classic example is the break up of AT&T some years ago into regional phone companies, who themselves later split into additional companies or merged with others. Each time one of these transactions takes place, the corporation will provide documentation on how to split the prior basis between the resulting companies. Tracking these events as they happen is very important, as it may be difficult to reconstruct the information several years down the road.
- **Broker fees** – Although broker fees are a deductible expense, they are generally already accounted for in most stock and bond transactions. The purchase price of a block of stock generally includes the broker fees, and the sales price reported to the IRS (gross proceeds of sale) is the net of the sales costs.

Depending upon the investment vehicle, tracking the basis in an investment can be quite complicated. If you have questions, please contact this office.