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Tracking of cost basis | Paul Pahoresky

By Paul Pahoresky paul@jlpcpas.com Jun 22, 2019



Trader Timothy Nick, left, and specialist Dilip Patel work on the floor of the New York Stock Exchange.
Richard Drew

When you invest in stocks or bonds it is critical to keep track of your basis in the investment. The IRS calculates a gain or loss by subtracting the basis from the sales price.

If the result is a positive value you have realized a gain on your investment, if the result is a negative value you had a loss.

If you owned the security less than a year the gain will be taxed as ordinary income. If you owned the stock for more than a year the gain will be taxed as a capital gain which is taxed at a lower rate than ordinary income.

The basis may sometimes be referred to as cost basis, adjusted basis, or tax basis, but regardless of the name that is used it is very important to accurately track this information.

However, the institution where the investment was sold through is required to issue a form 1099-B for the gross proceeds associated with the sale.

The taxpayer receives a copy of this form 1099-B and the IRS also receives a copy of this form 1099-B. Increasingly the form 1099-B will show basis, but that is not always the case. If the basis is not reported, the IRS automatically assumes the basis to be $0 resulting in the highest possible gain.

Essentially basis is the cost of the asset.

This figure is then used to compute the corresponding gain or loss when the asset is sold.

I cannot tell you how many taxpayers I have met who did not accurately track their cost basis and were not concerned about this until they received a notice from the IRS for incorrectly reporting a sale of an investment.

So, how is the cost basis determined?

For securities you have purchased the cost basis is what you paid for the investment plus any commissions you paid to acquire the investment.

Why track basis?

The best example is a dividend reinvestment in which dividends the stock paid were used to purchase additional shares. This also must be added in to the cost basis as you paid taxes each year on these dividends and these dividends added to your cost basis.

If, on the other hand you received the investment as a gift the calculation of the cost basis varies a bit, and is ultimately dependent on whether your sale results in a profit or a loss.

If you sell the security for a profit, your basis is the same as that of the previous owner. The basis of the previous owner is transferred to you along with the property transfer.

However, on the other hand, if you sell for a loss the basis is either the previous owner's basis in the stock or the value of the stock at the time of the gift, whichever is lower. This prevents a taxpayer from claiming a loss that occurred when the previous owner owned the security.

When you inherit stock or other assets your basis is generally the value of the asset on the date of death of the previous owner.

So, if the investment has appreciated since the original owner purchased it your basis is "stepped up" to the market value at the date of death.

As a result, the tax on profit that was generated while the previous owner was alive is effectively forgiven. You become responsible only for the tax that resulted from any appreciation after you inherit the stock, and if the stock price falls from the inherited value you can claim a tax loss.

When you are reviewing your investment portfolio consider the basis of individual securities.

Your investment manager should be maintaining these.

Most often we are focused on how our investments are appreciating, but it is worthwhile to review the basis as you will want to know the basis before the sale of the security.

Paul Pahoresky

Paul Pahoresky is a partner in the accounting firm of JLP CPAs. He can be reached at 440-974-1040x14 or at paul@jlpcpas.com. Consult your tax advisor for your specific situation for additional information and guidance on these topics.

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