

Cost Basis Reporting Requirements

New regulations for cost basis reporting become effective on January 1, 2011, as a result of the Emergency Economic Stabilization Act of 2008. Brokerage firms as well as other financial intermediaries will now be required to report cost basis information—along with gross proceeds—to the IRS when a sale or redemption occurs. This information will be required to first appear on the 2011 Federal Form 1099-B that will be issued in early 2012. In addition, the gain or loss will be classified as short-term or long-term based on the acquisition date of the security. The IRS will then compare these records to what is reported on the investor's tax return and any discrepancies must be explained by the investor.

Though not required by the IRS in the past, an investor may have been provided cost basis information along with gross proceeds on account statements and previous Federal Form 1099 forms. Cost basis reporting will now be mandatory under the new law for “covered” securities purchased in 2011 and thereafter.

Cost basis is an important starting point for calculating gain or loss when a security is sold. It becomes more complicated when there are multiple purchases, stock splits, mergers or dividend reinvestments. Accurate cost basis is crucial since it directly impacts the amount of an investor's taxable income. Brokers are required to adjust the cost basis on “covered” securities as necessary to properly reflect the correct amount.

Covered vs. Noncovered Securities Under the New Law

A security is considered either “covered” or “noncovered” under the new requirements.

Any security purchased before 2011 will be considered “noncovered” by the IRS and the cost basis information is not required to be reported to the IRS by your brokerage firm when the security is sold or redeemed. Therefore, securities held in accounts as of December 31, 2010, will be considered uncovered. However, an investor is still required to include the cost basis information when reporting the sale or redemption.

A covered security is defined as any security purchased in 2011 and thereafter where the broker will be required to report the cost basis information to the IRS when the security is sold or redeemed.

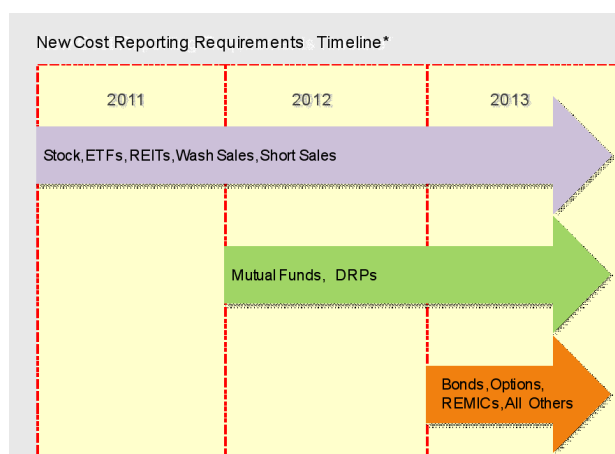
Covered Securities Phased In Over Time

The new law for covered securities takes effect at different times, depending on the security type and when it was purchased. The following schedule summarizes the tax year in which a specific security type becomes “covered” and therefore requires cost basis reporting to the IRS (please see Exhibit 1):

Tax Year 2011 – stock of a corporation (except those for which average cost is permissible), both common and preferred; exchange-traded funds (ETFs) and real estate investment trusts (REITs) including wash sales and short sales reporting

Tax Year 2012 – open- and closed-end mutual funds and securities purchased through dividend reinvestment plans (DRPs)

Tax Year 2013 – bonds, options, Real Estate Investment Mortgage Conduits (REMICs), and all other securities as deemed by the IRS.



* C-Corporations, non-profit organizations, IRAs and pension plans continue to be exempt from cost basis reporting on Federal Form 1099-B.

Choosing a Basis Determination Method

A security in a portfolio may be comprised of different tax lots due to multiple purchases or corporate actions. Each tax lot has a specific purchase date, unit cost and total cost. Investors have always had the ability to choose which tax lot to use when selling an investment. According to the new rules, investors must now formally elect a default cost basis method. We currently offer the following Default Basis Determination Methods:

LIFO – Last In First Out

HIFO – Highest Cost First Out

HCLT – Highest Cost Long Term

HCST – Highest Cost Short Term

LCFO – Lowest Cost First Out

LCLT – Lowest Cost Long Term

LCST – Lowest Cost Short Term

If an election is not made, brokers must use the FIFO method as the default. Investors will still be allowed to select a specific tax lot at the time of sale. This default election will only apply when another election is not made at the time of sale.

As a result, all sell orders will be processed on a FIFO basis unless the investor positively consents to a different default tax selection method for the account prior to the trade. The default can be changed at any time. Once the trade settles, the chosen tax lots cannot be changed at a later date. Investors should contact their tax advisor to identify the default method that best suits their financial needs and goals and communicate their preferred tax lot selection to their broker.

Adjustments to Cost Basis

In addition to purchases and sales, brokers are required to provide an “adjusted” cost basis and track events that may change the original cost basis of a security. The following events may affect cost basis:

Wash Sales – Securities with the same CUSIP within a single account will be analyzed by brokerage firms to determine if a wash sale has occurred. This is narrower than the formal definition of a wash sale that includes any “substantially identical” securities (even those with different CUSIPs) across all the investor’s accounts. The wash sale rules prevent losses from being deducted if substantially identical positions are purchased 30 days before or after a sale. While brokerage firms may identify some violations of the rule, they may not identify all violations. It is still the responsibility of investors to report traditional wash sales that are not identified by the broker.

Inheritance/Gifting – Besides identifying the specific tax lots of a position that is sold, investors must inform their broker of any adjustments to the cost basis from an inheritance or gift at the time of transfer. For gifted shares, this includes capturing the date of the gift, the donor’s adjusted cost basis, and the fair market value (FMV) of the shares on the date of the gift. Special rules may limit the loss that the gift recipient can claim when the shares are sold if the donor’s adjusted cost basis exceeds the FMV at the time of the gift.

If a broker has not received instructions or valuations from an authorized representative of an estate when inherited positions are transferred into an account, the broker must assume the cost basis is the fair market value of the security on the date of death of the original owner.

Corporate Actions – Cost basis must be adjusted for corporate actions, such as stock splits and spin offs.

Return of Capital – Cost basis must be adjusted for certain year-end reallocations, such as return of capital.

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Other Provisions of the New Law

Short Sales – Effective January 1, 2011, gross proceeds and the cost basis for short sales must be reported in the year the short sale is closed. This differs from tax year 2010 when short sales are reported in the year the short was opened.

Since short sale reporting is complex, investors should contact their broker for additional information.

Corporate Accounts – Effective January 1, 2012, the new law requires that S-corporations receive Federal Form 1099-B (Gross Proceeds) for any sales in their accounts. They are still exempt from all other Federal Form 1099 reporting including DIV, INT, OID, MISC, etc.

C-corporations will continue to be exempt from all Federal Form 1099 reporting for sales of securities purchased on or after January 1, 2012.

Delivery of Tax Statements – The deadline for issuing Federal Forms 1099 has been changed to February 15 rather than January 31 for each tax year. The IRS also allows brokerage firms to apply for a 30-day extension that moves the deadline to March 15.

What to Do Now

An investor must determine which default basis determination method is best for them prior to selling any investments. This new default will serve as a standing order that applies to all transactions, although the investor always has the ability to select specific tax lots for each transaction. The tax lot that is selected can be changed at any time, but no later than the transaction's settlement date. If the investor does not choose a default basis determination method, the default will be the FIFO (first in, first out) method as required by the IRS.

Keep in mind that the choice of a tax lot selection method only applies to the partial sale of a security position. All other non-trade transactions of partial security positions (i.e., movement between accounts, partial bond call, partial tender offer, gifting of partial position of shares) will be executed using the FIFO method unless other instructions are provided for each transaction.

Who to Call with Questions

Investors should contact their broker to discuss the new legislation so informed decisions can be made about their portfolio. Tax advisors can also assist investors with developing an appropriate strategy to minimize their tax liability.

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