Contact:
Leslie Bonacum — 847-267-7153, mediahelp@cch.com
Neil Allen — 847-267-2179, allenn@cch.com

SOLD STOCKS LAST YEAR? CCH OUTLINES WHAT YOU NEED TO KNOW BEFORE TACKLING SCHEDULE D

(RIVERWOODS, ILL., February 11, 2003) – If you were among the millions of investors contributing to the record outflow of dollars from individual securities and mutual funds during 2002, not only will you be precluded from filing a 1040EZ or 1040A income tax return, you'll be entering the confusing, unfriendly world of the Schedule D tax form, according to CCH INCORPORATED (CCH), a leading provider of tax law information and software.

Those who sold a home or valuable collectibles, or had capital gains distributions from mutual funds or real estate investment trusts, also have to fill out and file a Schedule D. Reporting these transactions, however, generally doesn't present nearly the challenge found in calculating capital gains and losses on securities.

"When you're dealing with a home, it's two discrete events: you buy a home at a point in time for a single price; you sell it at another point in time for a single price, adjusted for capital improvements," said Cameron Routh, CCH GainsKeeper market development manager. CCH GainsKeeper (www.gainskeeper.com) is the leading provider of automated tax-based financial tools and services for the investment community.

"But when you're dealing with securities, it's often a continuous, interconnected process rather than an event," noted Routh. "Individuals regularly add to their positions, sell and rebalance their portfolios; and even within an investor's portfolio, there's frequent change in the holdings as companies merge, spin off, undergo stock splits and take other corporate actions."

The Long and Short of It

The basic premise behind the Schedule D is to provide a place to detail capital gains and losses so that the total taxable gains or deductible losses can then be carried forward to the 1040.

To calculate gains or losses on your Schedule D, you first need to identify short-term gains and losses, and long-term gains and losses.

Long-term gains, those from investments held longer than one year, are taxed at the more favorable capital gains rate, which is no higher than 20 percent. Short-term gains, those from investments held less than a year are treated as income and taxed at your personal income tax rate, meaning as high as 38.6 percent.

If the number you arrive at is a loss for the year, the IRS will allow you to write-off up to $3,000 against your income for 2002. All other losses can be carried forward to write-off in future years.

While this seems simple enough, looks can be deceiving. In fact, the result of arriving at the correct gain or loss can be a major undertaking. Among the items investors want to keep in mind as they tackle the Schedule D:

Make sure to account for all corporate actions

Many people assume that the cost basis is what they paid for the stock or mutual fund at the time it was purchased. But, the basis changes each time a corporate action occurs. With more than 8,000 corporate actions annually, a particularly active stock may see several basis changes in the course of just one year.

Some corporate actions are manageable. For example, to account for a stock split, investors divide the total cost of the initial purchase by the new share amount to come up with an adjusted cost per share.

Other corporate actions, however, require more laborious calculations. For example, mergers can be either taxable or nontaxable depending upon the structure of the merger transaction. If shares you held in a company are exchanged for shares of a newly merged company, the basis of your old shares may carry over to the new shares or may need to be adjusted.

It is up to the investor to identify any corporate actions that effect their holdings, and to make all necessary cost basis adjustments for each security. Not accounting for these correctly could mean significantly overstating a gain, costing you more in taxes. In the event of an audit that finds you’ve understated your gains, you’d also be liable for back taxes, interest and other penalties or fines imposed by the IRS.

Check to see if you have any wash sales

A "wash sale" describes trading activity in which you sell shares of a security at a loss and within 30 days – either before or after that sale – you purchase a substantially identical security.

"Investors really need to think ahead when it comes to avoiding wash sales," said Routh. "Many individuals don’t realize that the rule applies not only to the 30 days after they sold a security at a loss, but also to the 30 days leading up to the sale."

Individuals who invest in mutual funds need to be particularly cautious. For example, if you make regular investments into a mutual fund, you may inadvertently find yourself in a wash sale situation if you go to sell shares for a loss.

If you do have a wash sale, your loss is deferred for tax purposes, and you need to offset the deferred loss with a wash sale cost adjustment on the newly acquired tax-lot. For example, say you sold 100 shares of AZA Motor Works Company for a total of $1,000 on December 2, 2002.

Your basis was $1,100, so you have a loss of $100. On December 16, you repurchase 100 shares of AZA for $1,000. Because the repurchase happened within 30 days of the initial sale, you have a wash sale situation. You can’t, therefore, immediately realize the $100 loss on the sale of the first 100 shares. You must adjust the cost basis of the second 100 shares purchased to include the deferred $100. So, the adjusted basis for the second 100 shares you purchased is $1,000 plus $100, or $1,100.

Plan ahead to lower taxes obligations for 2003

Waiting until it's time to file Schedule D to think about capital gains taxes can be a costly mistake. Keeping an eye on your gains and losses throughout the year, and figuring out the tax implications of buying and selling investments, can really help you reduce your capital gains taxes, noted Routh.

One example of this is understanding the different tax-lot accounting methods. The default method is first in first out (FIFO), meaning you sell your oldest lots first. In a rising market, these lots would have the lowest cost but the highest gain and, in turn, the more taxes owed when sold.

"There’s no right or wrong method," said Routh. "But it is possible to reduce the taxes you have to pay by selling your highest cost shares first. Better yet, sell a lot that has a loss, so that you can offset a gain you realized on a prior sale."

In addition to the FIFO and Specific ID methods, mutual fund investors can choose from two additional rules for figuring their gains or losses. One method uses a single average price for all the shares. The other divides the shares into short-term and long-term holdings and calculates an average price for each group.

However, if you use either of the two averaging methods for mutual funds, you can’t switch to the FIFO or specific ID method for future sales of the same fund without first getting IRS permission to do so.

Good recordkeeping can save time, lower costs

Your brokerage firm will provide you with a Form 1099-B listing all the stock sales you made throughout the year. But, the 1099 does not identify which tax-lots those sells were applied to, what your gains or losses were or whether they were short or long term. As a result, it’s up to individual investors to track cost basis and calculate their own gains and losses.

"Whether you do your taxes on your own or you use an accountant, someone has to try to recreate the cost basis if you haven’t been keeping track of it along the way," said Routh. "Knowing your gain/loss situation throughout the year will save you time, and possibly a great deal of money, at tax time."

About CCH INCORPORATED

CCH INCORPORATED, founded in 1913, has served four generations of business professionals and their clients. CCH GainsKeeper (www.gainskeeper.com), based in Quincy, Mass., is the leading provider of automated tax-based financial tools and services for the investment community and is a division of CCH. CCH is a wholly owned subsidiary of Wolters Kluwer North America. The CCH web site can be accessed at cch.com.

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