

Working with the IRS when records are missing

When your old portfolio has incomplete documents, finding a cost basis to avoid paying taxes twice is tough.

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The \$500 that James and Dorothy Mellberg plunked down on a mutual fund in the early 1950s turned out to be one of the smarter investments they ever made. By 2006, the investment was worth \$50,000.

At that point, the retired couple from Palo Alto, Calif., planned to sell the fund. But soon after, a problem arose: They could not determine what they would owe in taxes.

On paper it seemed that they had a \$49,500 profit. But that wasn't true. Every year the Mellbergs had paid taxes on capital gains reported by the fund but left inside it and not paid out to them. Trouble was, they didn't have any records for the first 25 years or so of their investment.

"That's what we ran up against," says Mrs. Mellberg. "How do we establish a basis, or a cost, so we could pay taxes?"

Therein lies a wrinkle for many long-term investors – figuring out a cost basis. The calculation is difficult for owners of stock in which dividends are reinvested to buy more shares over years or decades. And it's particularly nettlesome for mutual-fund investors, since by law they have to report capital gains every year and are liable for taxes on those gains, even when no actual distribution of the gain is made.

"You've already paid taxes on this. Don't do it a second time," advises Rob Williams, a certified financial planner in Columbia, Md.

The government is willing to go along with that and it allows investors to deduct the amounts they have already paid taxes on. But naturally, the Internal Revenue Service wants some documentation. Mr. Williams says the first move is to pick up the telephone.

"Call the mutual fund, and ask them" for records, says Williams. The fund should be able to document every capital gain that it paid and how many shares were purchased with reinvested dividends.

With the Mellbergs, though, that didn't work. The fund's ownership had changed hands several times, and even the name of the fund had changed. So the records they sought – from the early years, at least – just weren't available.

Fortunately, the IRS has devised three basic ways that investors with incomplete records can compute cost basis and stay out of trouble:

- **Specific identification.** This is when investors sell specific shares from their portfolio, in this case only the shares for which they have documentation. The Ernst & Young Tax Guide 2007 marks this as the most flexible way to determine gains or losses. But this only works when you know the price of each share.
- **First-in, first-out (FIFO).** You assign to the shares sold the cost of the first ones you bought. This could produce the largest gain, says Robert Burkarth III, a certified financial planner in Stamford, Conn. Then again, if your investment has lost money, it likewise could produce the largest write-off.
- **Average cost.** This method lumps together the cost of all the shares, then computes an average cost. If you bought 100 shares at \$20, then later acquired 50 shares at \$30, you spent \$3,500 and own 150 shares with an average per-share cost basis of \$23.34.

"Typically, people do average-cost basis when they throw their hands up in the air," says Mr. Burkarth of investors who have little documentation.

This could be a strategy to consider if you're not selling your entire position. For instance, even though FIFO could produce a bigger tax bill for a gaining stock or fund, Burkarth says that it might be a good option if you believe that capital-gains taxes in the future will rise. "It depends on why you're selling," he says of the range of options.

Sometimes, records are so far gone that it is extremely difficult to come up with an orderly computation of cost basis. In those cases, Williams advises producing some sort of methodology that tracks your cost basis over time. "There are some cases where the IRS will say 'give us something to go on,' " he says.

Because of the complexities involved, Williams makes a plug for turning to financial advisers such as himself for help. They typically have software that can track prices, dividends, and capital gains.

Do-it-yourselfers might turn to Phoenix-based NetWorth Services Inc. (www.networthservices.com), which works with individual investors to help them determine cost basis.

As for Dorothy Mellberg, she still hasn't sold her mutual fund. Her husband passed away late in 2006, forcing a delay in the sale. That has introduced yet another complication in the cost-basis calculation of the fund, though in this instance, it works to her financial benefit. With her husband's passing, Dorothy inherits his share of the mutual fund with a cost basis that is "stepped up" to the value on the day of his death. That lessens her tax bite further.