

**With January 1, 2011
in the Rearview Mirror,
How are Firms **Complying**
with the New Cost Basis
Reporting Regulations?**

**An Overview and Analysis
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Abstract

This paper examines where the financial services industry is situated today relative to the demands of the new Cost Basis Reporting obligations which began taking effect January 1, 2011. The principal legislative objective of the regulations is to increase the accuracy in reporting of gains and losses by taxpayers on their income tax returns. While the ability to make a determination about the success of this legislative objective is still years off, there is ample information to draw certain conclusions about the financial services industry's ability to serve as a linchpin for accurate taxpayer gain and loss reporting. Sources of reference come from a Cost Basis Survey taken by the Financial Information Forum in January 2011, information obtained at various industry events and seminars, direct broker to consultant gathered information and other sources of professional interactions on the subject of Cost Basis Reporting. The Survey results are used as a starting point for many of the discussions which then draw upon the other frames of reference. At appropriate points, solutions that Jordan & Jordan can provide to assist a firm in meeting its cost basis challenges will be highlighted. It is the intent that this article will provide the reader a greater understanding of general trends and issues emerging on the Cost Basis Reporting landscape and be motivated to take the necessary actions to ensure firm compliance and customer satisfaction. In that regard, Jordan & Jordan can provide services to assist a firm in doing so.

Introduction

Cost Basis Reporting is now the law of the land. On January 1, 2011 the concepts of "Covered and Specified Securities", "Basis Transfer Statements", "Default Methods", and the "475 Mark to Market Exemption" became a permanent part of the financial services vernacular. Other concepts such as a broker providing cost basis as an accommodation for tax preparation or taxpayers wrongly waiting until year end to select tax lots to match against securities sales on their Schedule D's are now a thing of the past. Despite the subliminal rancor felt by the financial services industry (the "Industry") toward the Internal Revenue Service (the "IRS") because of the extremely short lead time from the distribution of the final cost basis regulations in October 2010 to their initial stage of phasing in on January 1, 2011, the Industry has managed to survive, and in part, due to penalty relief help from the IRS. So where does the Industry stand now with phase one? How are financial institutions complying with their cost basis tracking obligations? Will they be prepared to handle the tax reporting side of cost basis at year end? What about preparing for phases two and three? And perhaps most importantly, how are customers reacting to cost basis tracking? Do they really understand its implications for their investment strategies? Or will their year-end 2011 tax reporting be filled with angst and confusion, not to mention many more 1099-Bs? These and other topics will be examined in this paper. But first let's take a quick walk down memory lane and revisit the road to Cost Basis Reporting.

A Look Back

The desire of the government to require tax reporting agents to provide basis information along with proceeds of sale on a 1099-B has probably been around as long as proceeds reporting has been. Serious interest in making this desire a reality gained steam when the first Simplification Through Additional

Reporting Tax Act (the “START Act”) S. 2414 was proposed in 2006 by Senator Evan Bayh¹. Based upon a recommendation made by the National Taxpayer Advocate, the START Act sought to require brokerage houses and mutual funds to track and report taxpayers' adjusted basis information initially for stocks, bonds, and mutual funds. For other securities, the bill left discretion in the hands of the Treasury Secretary. The START Act created reasonable cut outs for “cases where it will be difficult or impossible for companies to provide accurate basis information.” These cases included gifts, bequests, and cases where unique basis adjustment rules come into play like wash sale rules. However, that START Act was never started. In the two years that followed six bills were introduced in the House of Representatives and three were introduced in the Senate all addressing cost basis as a means of increasing revenues. None of these bills ever made it through the legislative process, but then in the latter days of 2008 amidst the financial crisis, the Emergency Economic Stabilization Act of 2008, H.R. 1424 (“EESA”) was passed². Section 403 of Part B of that law addressed cost basis. Contrary to the original START Act, within the legislation itself, the scope of securities to be covered was expanded, basis tracking was mandated for gifts and inheritances, and tracking wash sale activity for the same CUSIP within the same account was also required.

Subsequent to the enactment of EESA, in February 2009, the IRS posted Notice 2009-17, “IRS Request for Comments on Reporting Customer’s Basis in Securities Transactions” (the “Notice”). Comprised of 36 questions, the Notice sought industry feedback on many cost basis issues. After comments were submitted in early March, communications between the IRS and Industry representatives quieted significantly. The silence led to some frustration as many of the respondents to the Notice believed further elaboration and clarification of their comments were required, given the complexities of processing securities transactions. Some firms felt an urgency to prepare for cost basis reporting even though they were left to fill in the blanks as far as what the regulations would look like when issued.

After a period of ten months, in December 2009, the IRS issued proposed cost basis reporting regulations (REG-101896-09). Comments were invited by February 8, 2010 and a public hearing was scheduled for February 17, 2010. This provided industry participants less than two months to review the 139 page document and provide feedback. The Financial Information Forum³ (“FIF”) sent representatives to the public hearing to express the organization’s collective viewpoint on key issues. Reports back were that those who spoke with the congressional and IRS representatives on the panel appeared to have had a greater level of influence through direct dialogue than most comment letters had. However, given the limited speaking time for those present, only the most critical of issues were focused upon.

It took another ten months from the proposed regulations to the issuance of the final regulations (TD 9504) (the “Final Regs.”) on October 12, 2010. With less than three months to Cost Basis Reporting - Phase One going live, firms scurried about to incorporate changes from the preliminary to the final

¹ Senate Bill S. 2414

² Sec 403 – Cost Basis Reporting HR 1424 / CBR Final Reg 2010 – TD 9504

³ www.fif.com

regulations in order to beat year-end code promotion freezes. Although the Final Regs. did not delay any of the effective dates, they were issued along with IRS Notice 2010-67 which granted limited penalty relief for certain cost basis transfer activity. Now there was no longer time for voicing further concerns or lamenting about how the Final Regs. didn't reflect prior concerns about tracking basis on gifts, monitoring the dividend reinvestment plan's ten percent requirement or adequately addressing the voluminous tracking of wash sales. It was time for the Industry to roll up its sleeves and get to work preparing for Cost Basis Reporting - Phase One.

Living with Phase One – Industry Perspectives

The new cost basis reporting requirements established an implementation schedule for when various security types would become covered and thus subject to 1099-B basis reporting. The phase-in of security classes is as follows:

Implementation Date	Security Class
January 1, 2011	Equities, except those participating in qualified Dividend Reinvestment Plans (DRPs)
January 1, 2012	Mutual funds (regulated investment companies) and equities participating in DRPs
January 1, 2013	Debt securities, options and other specified securities

According to the phase-in schedule equities are the only securities that the Industry has had to concern itself with for year end 2011 tax reporting. And this has been quite enough! The Industry has sought to cope with the implementation of cost basis through many vehicles. Industry associations, business-related social networking site groups, vendor user groups, and other gatherings of industry professionals have been organized to share information and interpretations of the regulations, experiences with processing cost basis to date, and where feasible, to create joint or common solutions. The FIF has been at the forefront of these types of activities with its members. As part of its implementation tracking efforts, the FIF conducted the cost basis survey referenced above earlier this year. This survey, which focused on progress to date with programming and testing for the requirements and development remaining to meet the January 1, 2011 deadline, the early preparations for 2012 and 2013 compliance, also included a breakdown of Industry project costs (2011-2013). Many of the responses received are in line with the experiences this writer has encountered via consulting engagements, participation in networking sites and attending FIF or other industry events and thus survey results will be presented and matched or contrasted with actual Industry experiences.

To put the current state of the industry's cost basis implementation into one word, it would be "challenging." In two words, it would be "extremely challenging." This is not to say that firms will fail in ultimately meeting their cost basis reporting obligations at year end, but there are bound to be problems with the accuracy and timeliness of 1099-B basis information. Through its Cost Basis Working Group, the FIF has assisted its members in addressing implementation issues associated with the new cost basis requirements since it initiated the working group in 2009. Continuing its track record of

sharing information and ideas between members, the FIF's recently published third Cost Basis Survey (the "Survey") sought Industry input on the following:

- Identifying existing Cost Basis Support and Reporting Functionality
- CBRS/Non-ACATS Participation
- ETFs and RICs
- Implementing Cost Basis Changes and Education Challenges
- Getting Ready for 2012 and 2013

Survey respondents included both FIF and Non-FIF members. Specific Industry respondents came from the following groups: Banking Institutions and Custodians, Broker Dealers, Transfer Agents, Service Bureaus, Third-party Cost Basis Solution Providers, Tax / Cost Basis Consultants and Other Support Entities. This broad range of firms have also been represented in networking groups on Linked-in, at industry events and in client working groups sponsored by vendors.

Security Types Serviced

In the first set of questions designed to identify existing cost basis support and reporting functionality, the Survey participants were asked about the types of securities they supported currently, and lot relief methodologies being used, including standing order instructions. Equities, Options, Fixed Income and Mutual Funds were the four security category choices available to participants as far as currently being supported. All respondents that were responsible for maintaining tax-reportable accounts for clients or as cost basis service providers to such firms stated that they were handling equities. Mutual Funds were the second most serviced security with 83% of respondents providing support. Fixed Income and Options are supported on a limited basis by all responding Service Bureaus and by over 80% of Broker Dealer respondents. While the responses were limited as to explanation of the level of service provided for any of these security types, it is safe to say that much work remains to be done, even for equities. In fact, one of the Survey questions focused on a firm's ability to differentiate between a Regulated Investment Company ("RIC") and an Exchange Traded Fund ("ETF") that is not a RIC for purposes of treatment as covered securities in 2011. Survey participants were asked if their systems can distinguish ETFs from RICs since those ETFs that are RICs will be subject to reporting in 2012 while other ETFs may be subject to reporting in 2011 or 2013 depending on the final regulations and legal status of the security. Over 58% of respondents indicated they would differentiate ETFs from RICs, which included all Cost Basis Solution Providers, 70% of Broker Dealers and half of Service Bureau respondents. For those firms that are treating all ETFs the same, a majority of them are taking a conservative position and will consider all ETFs to be covered in 2011.

Experience has also shown that firms are encountering difficulties associated with tracking of 'qualified' Dividend Reinvestment Plans (DRPs) in order to exclude DRP participating equity shares from being considered covered in 2011. Section 1012(d)(4)(A) of the Final Regs. defines a dividend reinvestment plan as an arrangement under which dividends are reinvested in identical stock. The plan qualifies as a DRP if the written plan documents require that at least 10 percent of every dividend paid on any share

of stock is reinvested in identical stock. Making this determination, plan by plan for equity issuers, has been problematic for some firms. While firms can take a conservative approach by treating all equities as covered this year to avoid penalties associated with mislabeling covered shares as non-covered, it is expected that this issue will surface again once the tracking of DRP shares using average basis becomes a required lot relief / valuation offering in 2012.

The RIC / ETF differentiation issue and the DRP identification issue have been raised in online networking groups. The answer to “Does anyone know of a vendor that will provide a feed that will determine if a Dividend Reinvestment plan is qualified or not?” was a simple “no” from group members. The question “Does anyone recommend a good vendor for identifying and monitoring the status of RIC securities?” did elicit some vendor names as possibilities. However, some responses reflected a certain lack of sureness in the rule requirements. Specifically the requirement that a plan qualifies as a DRP if the written plan documents require that at least 10 percent of every dividend paid on any share of stock is reinvested in identical stock was not clearly understood by some commenters. So, the work of educating Industry personnel must continue. In an effort to assist its members in preparing to understand the issues in tracking basis for fixed income instruments and options the FIF is preparing a strategy for its members to delve into basis tracking and the reporting of these security groups. Some of the questions facing the Industry related to fixed income and options are discussed below in the “Getting Ready for 2012 and 2013” section. Jordan & Jordan can assist firms in educating their personnel to better understand the cost basis rules through its Cost Basis Education Package. Additionally, Jordan & Jordan can help a firm that is seeking service providers to fill in cost basis reporting gaps through its vendor review, evaluation and selection services.

Basis and Lot Relief Methodologies

When questioned on support for cost basis accounting methodologies, all Survey responding Broker Dealers and Cost Basis Solution Providers indicated support for FIFO, and while all Cost Basis Solution Providers supported Average Cost, only 50% of Broker Dealers respondents with in-house solutions were capable of supporting Average Cost. All Service Bureau respondents supported FIFO and 83% claimed support for Average Cost. For Average Cost eligible securities, participants were asked if they were planning to default to this disposal method. More than half of the affected respondents said no, 24% said yes and 16% remained undecided. Those firms that answered positively were additionally asked which asset types would Average Cost be utilized for. All positive responders selected open end mutual funds and less than 50% selected DRPs, closed end mutual funds or eligible ETFs. Although the cost basis regulations require that clients must be able to specifically identify tax lots for sale, there are no requirements to make standing instruction methodologies available. However, standing instruction methodologies that comply with IRS rules can be offered. While the results of firms that offer standing orders primarily indicated support for Last-in First-out, Highest Cost and Lowest Cost, one respondent commented that it would consider developing new standing instructions based upon client requests.

While offering lot relief and basis methodologies seem straight forward the Industry has been wrestling with quite a few details beneath the apparent simplicity of selecting or valuing a tax lot. Experience with lot relief and valuation methodologies has revealed some challenges not considered before. One such

challenge is the application of a standing order lot disposition method such as least cost or maximum gain when an account maintains positions in the same security of both covered shares and non-covered shares without basis information. While the regulations only require drawing down non-covered shares with basis unknown if FIFO is being applied, when a standing order method is being used the broker needs to communicate to its clients that the method will only be applied to shares having basis or acquisition data sufficient to apply the standing order. If there is an expectation on the part of the customer that all positions will be considered (including those where basis may not be known for certain by the broker) then this expectation must be changed. Prudence dictates that firms inform their clients that in instances where basis is unknown for certain lots of a particular security position, clients need to supply specific ID versus purchase instructions. It is important to educate clients to provide such instructions no later than settlement date.

A critical issue has arisen for the mutual fund industry surrounding the use of Average Cost as a default. Under the default rule, a taxpayer who holds shares in an account for which the broker's default method is Average Cost must elect a basis method immediately upon opening a new account or upon acquiring new covered securities in an existing account. If the taxpayer fails to make such an election and the account defaults to Average Cost, the taxpayer may change methods prospectively only, even if no redemptions have occurred. This provision thus eliminates a taxpayer's opportunity, when he or she redeems shares, to choose which basis method to use and, consequently, which shares to redeem. The mutual fund industry believes this rule makes it far less likely that brokers and funds will choose Average Cost as their default method. The IRS has yet to respond to the Investment Company Institute which submitted a comment letter to the IRS about this in January⁴. If however, a customer were to elect average basis he can revoke within one year (possibly longer) or up until the first sale. Such revocation would result in all tax lots being valued at their acquisition price and not at the average price. The Industry has cited soliciting average cost elections from every customer (in writing or electronic form) as an unnecessary hardship that could be avoided by simply permitting revocation when average cost is used for a default. The IRS's response will certainly provide for interesting reading.

The FIF Survey also targeted a mutual fund question about the Single Account Election. Subject to customer Average Cost election, the question asked participants if they intended to utilize the Single Account Election for eligible Average Cost assets. 39% of respondents said yes, 43% said no and 14% chose 'none eligible'. With regard to the Single Account Election, the release of the IRS's 68 Frequently Asked Questions on March 7, 2011 on its website virtually ended the possibility of its use by many firms⁵. The following is what was published:

“55. Brokers may make the single-account election only for noncovered mutual fund or DRP stock for which they have accurate basis information. Must a broker know whether a taxpayer previously averaged mutual fund or DRP stock held by the broker?
Yes. Accurate basis information includes whether the basis of stock held by the broker

⁴ ICI Letter re Cost Basis Reporting, January 13, 2011

⁵ <http://www.irs.gov/taxpros/article/0,,id=237099,00.html>

previously was averaged by the taxpayer. A taxpayer makes the average basis method election for noncovered mutual fund or DRP stock on the taxpayer's return and, for stock sold before 2012, must average the basis of all identical stock held in any account. Therefore, a broker should exercise caution in making a single-account election for mutual fund or DRP stock if a taxpayer may have averaged the basis with the basis of stock held by other brokers."

Can any broker state with absolute certainty that it knows how a customer averaged the securities in question prior to a Single Account Election? While perhaps some fund companies with all the necessary registration information may be able to determine if they have held all of a customer's shares, it would seem that other Industry players could never be certain. It should be noted that the FIF Survey was taken prior to the release of the FAQs so the responses to this question may no longer be valid.

Client Communications and Training

The new cost basis reporting requirements not only demand extensive systems changes, enhancing data processing capabilities and tax reporting functionality, but they also require comprehensive client communications and documented procedures to ensure a successful implementation and ongoing execution. The FIF survey asked questions about various types of useful functionality that could support the customer experience. One such question concerned functionality that would give the customer (end user) the ability to make cost basis changes and export cost basis data. Approximately 50% of survey respondents indicated they would allow customers to make changes for non-covered assets. Those firms that indicated customers would not be permitted to change basis regardless of whether the securities were covered or not all indicated that changes for any assets would have to be made by operations or other firm personnel through administrative programs.

With regard to changes that customers could expect to see, participants of the FIF survey were given four scenarios to determine which would cause reporting changes to online screens and to monthly statements. The scenarios were:

- Marking lots covered / non-covered,
- Noting when cost basis has changed due to a corporate action / wash sale / option assignment, etc.,
- Displaying bifurcated Average Cost,
- Displaying default method at position level

85% of respondents responded positively to 'marking lots covered/non-covered', making this the most popular scenario for updating statements and online presentations. More than 50% selected 'noting when cost basis has changed due to a corporate action/wash sale/option assignment, etc.' and 'displaying bifurcated Average Cost', while slightly less than half selected 'displaying the default method at the position level'.

Survey participants were also asked to identify challenging topics from a training perspective. Over 50% of respondents listed gifts and inheritance as challenging training topics, followed closely behind by transfers. A third of participants indicated that they found all topics challenging for training. Additional topics identified as presenting significant challenges included wash sales and corporate action adjustments. The phase-in of effective dates and the concept of covered / non-covered were considered the least challenging training topics. Two of Jordan & Jordan's cost basis services can be very helpful to a firm that is dealing with the issue of training its personnel. As previously mentioned Jordan & Jordan's Cost Basis Education Package can bring staff members up to speed on the regulations quickly and comprehensively. The 12 module program covers various cost basis topics including short sales, wash sales, transfers, lot relief methodologies, and others. Additionally, Jordan & Jordan provides a compliance audit service that in part is designed to review cost basis training programs and website materials. These services, taken separately or together, will enable a firm to achieve the levels of cost basis knowledge necessary to implement the three year phase in.

A rather surprising customer experience issue that is developing relates to options. Many firms are capable of linking option premiums with the underlying securities that were bought or sold when the option was exercised. This linking can actually be carried through to the filing of a 1099-B. However, since securities that are being transferred are not required to be linked to option premiums until 2013 a firm will not know if an option has been folded into the underlying securities that have been transferred in. Thus the firm may be creating a 1099-B for some securities that have premiums as part of basis and other securities that may or may not. This is an issue that requires disclosure to customers who are transferring in securities. If not alerted the customer may not properly prepare his Schedule D.

Another area where some firms are getting out in front of the competition related to the customer experience is in their disclosures of various impacts the customers can expect due to cost basis reporting. The following highlights some required and other practiced disclosures that firms are making.

Required:

- Default Method
- Confirmation of specifically identified securities transactions

Optional:

- Firm will be reporting non-covered securities to IRS
- How firm will calculate wash sales and contrast that with taxpayer obligations
- Description of Standing Order Types available
- Notice to RIA clients about firm being final cost basis for IRS purposes
- Notice to all clients that firm's cost basis as of settlement date is final for IRS purposes
- The extent of information transferred on a non-covered security
- Disclosure to new customer of failure of prior broker to transmit cost basis data
- Distinction between RICs and other fund products

The firm that educates its customers the most successfully will be able to turn cost basis compliance into a competitive advantage. Jordan & Jordan's educational materials and subject matter experts can help a firm achieve this.

Transfers

Given the magnitude of transferring cost basis and the issues that can arise from improper transfers, the FIF survey targeted several questions on the Depository Trust & Clearing Corporation's ("DTCC") Cost Basis Reporting Service (CBRS) which can be used with the Automated Customer Account Transfer Service (ACATS) of DTCC or for Non-ACATS transfers as well. CBRS is designed to facilitate the secure passage of cost basis information when assets move among firms by creating a centralized and standardized communications hub allowing firms to eliminate potential inaccuracies associated with sending paper documents. With CBRS evolving into the primary center of the Industry's structure for transferring basis, FIF sought to learn about the level of Industry participation in the service. 96% of survey respondents stated that they planned on participating in CBRS by January 1, 2012 when the penalty relief granted under IRS Notice 2010-67 is due to expire. 77% of those firms were confident in being ready by the end of the first quarter of 2011. As part of transitioning to the transfer of basis along with accounts or positions, firms were questioned if they would, on an interim basis, not send transfer statements, send manual statements with cost basis or were already transferring basis via CBRS. Of the respondents, about 70% were already using CBRS, 17% were sending manual statements with cost basis and 13% were not sending transfer statements at all until 2012. An additional question on the transfer topic focused on the process of sending a transfer statement to a firm in 2011 that is not participating in CBRS (Figure 17). 68% of respondents said they would send a transfer statement. 55% of Broker Dealer respondents will not send transfer statements to them.

A scenario on firms following-up on occasions when basis is requested but not received within 15 days drew a mixed response. 57% of firms will follow-up further on all occasions, 30% will not follow-up and the remaining 13% indicated they would follow up with CBRS users only. But what happens when some transferred tax lots include basis and others do not? Are brokers following up on these securities or can their systems even determine whether follow up is required? This is just another issue that has arisen and is being examined within the Industry at this time.

In addition to getting systems up to speed for handling transfers, the Industry is facing issues with transfers that were not in focus during the frenzied run up to the January 1, 2011 implementation date. One such issue is how a system handles reshuffling of wash sales after a transfer in of securities. Some wash sale engines that are called upon to reshuffle tax lots when a subsequent event has occurred to create or continue a wash sale string, are not able to omit the transferred in securities from the reshuffling. Since those securities were not in the account at the time of the earlier sales they are not eligible to be used in the string even if those shares that were transferred in have dates that would warrant their being washed. This is just another of many unique issues being uncovered.

One other transfer issue that is worthy of mention and is a bit of a challenge is the varied degree to which firms are reporting on transfers in 2011. Some firms are doing CBRS only on ACATS, some are

doing it only for equities and not other assets that are transferring, some are sending paper statements and others are not, some are sending the 15-day requests and others are not. From a customer service perspective it makes it difficult to assure a customer that the accurate cost of the securities has been received. As one industry person said, "As time goes on it will become clearer who is doing what and firms will start to get their systems up to speed but in the meantime it is a struggle. We are finding this to be one of the bigger ones to overcome simply because our clients expect all cost to be updated as much as possible."

As previously noted, IRS Notice 2010-67 effectively moved the compliance date for transfers to January 1, 2012. Will your firm be ready? Jordan & Jordan has provided Cost Basis Risk & Readiness assessments prior to the January 1, 2011 equities deadline and can do the same for a firm's transfer preparedness prior to January 1, 2012. The Jordan & Jordan review addresses topics such as the elements of transfers including gifts and inheritance, procedures needed, the handling of physical and CBRS information, and process improvement suggestions.

Other Considerations of Note

As stated above, the concept of offering Average Cost as a default basis will not be workable according to the mutual fund industry if the revocation rules aren't changed. But even if they are changed, many firms are rethinking the benefits versus the detriments for their customers and themselves. Use of average basis mandates FIFO, thus a customer's holdings will have a bias toward short term and there will never be an ability to match specific lots with sales when it would be more beneficial to the taxpayer. The regulations require a written notification of change from a customer when he wishes to use an alternative valuation method, thereby causing the potential for additional work when a customer no longer wants to use Average Cost. The broker also has some issues with mutual fund or DRP shares that have been gifted to a customer as some may not be eligible to be averaged without a customer writing. There is a prohibition on the use of Average Cost basis with gifted securities if the basis of the shares in the hands of the donor, or the last preceding owner by whom the shares were not acquired by gift, was greater than the fair market value of the shares at the time of the gift. In order to permit the use of the Average Cost method the customer must provide the broker, in writing, a statement that the customer will treat the basis of the gift shares as the fair market value of the shares at the time they were made a gift. This is just one further concern for a broker using average cost as its default.

A general challenge that firms are also dealing with is that the Cost Basis Regulations are not totally self-contained but rather include other areas of tax law. This has led to many internal discussions and debates over the treatment of particular transactions as far as tracking basis and monitoring the nature of transactions. This is evident in wash sale and short sale transactions. The short sale rules state that the date of delivery of the shares to close a short position is used in determining when a short sale is closed. A buy to close would incur delivery on the settlement date, but the closing of a sale with transferred securities does not have a settlement date. Rather there is a receive date or a journaling date from another account. And with regard to journaling of transactions, many brokerage back office systems have not been capable of journaling at the tax lot level. But with the need to journal specific lots in the back office system, further modifications are being made to older systems. Another tax

matter that arises when handling a short sale occurs when such a transaction that is profitable is closed over a year-end. This would spring the constructive receipt policy into play for the taxpayer, but the reporting agent is required to report the sale in the year the buy to close settles. Understanding issues like this can help a firm to support its customers' cost basis experiences, but such knowledge is not typically had by cost basis subject matter experts.

The need to understand how wash sales are created and monitored is a critical element for a better customer experience. Some systems have failed to treat short wash sales in a manner similar to long wash sales despite the requirement to do so. Instead, some systems have looked upon a sell / buy / sell as a buy and a sell and then a new short sale. If another buy does not occur within the 61 day window the system does not recognize a wash sale. It would simply have an open short sale on the books and a buy and sell that has closed. However, the actual treatment of such a transaction has the second sell reestablishing the first sell and thus a wash sale. Without knowledge of the wash sale rules a cost basis subject matter expert may not arrive at the correct answer. Firm subject matter experts are struggling with such interpretive questions and, at times, are seeking guidance in matters such as this. Jordan & Jordan can bring its expertise to assist with such questions. Whether it is for resolving issues related to equity transactions today or understanding the issues that will challenge the application of the cost basis rules to mutual funds, DRP shares, options or fixed income, Jordan & Jordan can provide answers and solutions.

Getting Ready for 2012 and 2013

With firms having completed the bulk of the work to prepare for 2011, most of the Survey participants were already focusing on getting ready for 2012 and 2013. The FIF Survey tailored certain questions to evaluate how firms were preparing to meet the January 2012 deadline for mutual funds and DRPs and how they were going to address the final regulations for 2013 once distributed.

To determine the change in a firm's operational staffing, participants were asked to determine the increase in staffing needed to ensure cost basis integrity for 2011 and whether they foresaw additional growth for 2012 and 2013. 65% of participants have seen an increase in operational staffing. One service bureau participant indicated the group supporting cost basis accounting and tax reporting products had nearly tripled in size. 19% of participants have seen no increase in operational staffing. With regard to the time necessary to prepare for 2013, 75% of respondents feel final regulations are required at the minimum 6-18 months in advance to prepare for 2013. 14% of respondents thought it would require more than 18 months to prepare for 2013. Feedback from the IRS concerning the drafting of regulations for phases two and three, particularly options and fixed income, indicates that staffing changes have occurred and that the new personnel need to get up to speed on cost basis and securities processing. It would seem that the Industry will be heavily occupied by cost basis for the next two years and that the final regulations for those phases may also be distributed with short lead times.

As noted above, FIF members are working on a strategy to set out the major challenges for 2013. In that regard a series of questions for fixed income and options is being looked at with regard to creating cost

basis capabilities for tracking and reporting. The following is but a small sample of questions being discussed:

- When amortizing bonds, are firms amortizing yield to maturity or yield to worst call?
- Are firms capable of performing straight line or scientific amortization for all bonds (or both depending on the bond type)?
- How is amortization being handled when bonds are redeemed?
- How are factorable bonds handled?
- How should continuously callable bonds be amortized?
- Can a firm's system amortize foreign denominated bonds?
- Since there is no current 1099-B reporting of proceeds for options what can be expected? Will expired purchased options be reported on 1099-Bs with zero proceeds? Will expired sold options be reported on 1099-Bs with zero basis?
- How will a deferred account that tracks option premiums be handled from one year to the next? Especially when an account is being transferred with deferred balances?
- What will it take to enable a cost basis engine to track and link options and equities for wash sale purposes? Will it be necessary?
- When should a 1099-B be issued to a seller of an option? The year in which the option is sold? Or when it is closed out? Will it depend upon whether the option it is covered or naked at the time of the sale?

There are many other issues the industry is wrestling with currently in preparing for 2012 and 2013. Discussions with industry participants indicates that many firms are not finished with their Sub S Corporation identification solicitations. This is one of many necessary documentation related matters that have been put on the back burner as firms addressed the prominent issues of getting basis accurate for tracking and reporting. Among the other documentation approvals or responses required that may not be receiving the attention they need are:

- Lot Relief Selections and Specific Identification Selections and Confirmations
- Statements on account transfers regarding the nature of the securities are being transferred (gift or not)
- DRP Participation and Withdrawal Documentation
- Average Basis Election, Revocation and Prospective Change Documentation
- Letter for Use of Average Basis for gifted shares when basis is greater than FMV in Donor's hands
- Agency Authorization for RIAs selecting Lot Relief Methodology for clients
- 475 Mark to Market Letter
- Information on a gift transfer – in and out (Donor's Basis and Acquisition Date)
- Information on an inheritance transfer – in and out (Estate Representative / Legal Documentation)

As the clock ticks down to 2012 it should be noted that along with being required to track basis for mutual funds and DRP shares, transfer basis in and out for all covered securities, and be engaged in the first tax reporting season with cost basis attached, there may also be a major influx of corporate action adjustments. Since IRS Notice 2011-18 effectively delayed the need for corporate issuers to release information about 2011 corporate actions until January 2012, the expectation is there will be a flurry of such notices and needs for adjustment in January. The IRS is currently developing the form and manner of an issuer return contemplated in the cost basis regulations, as well as considering what additional information, if any, is to be provided on such return. Thus, issuers cannot absolutely furnish the information to the Industry until the IRS creates the form for furnishing corporate action information. This of course will have impacts on processing of all sorts. Wash sale adjustments, the issuance of corrected transfer statements and possible delays in creating 1099-B files are expected to be a major drag on the Industry as January 2012 begins.

There are many other issues, events and challenges that have not been discussed in this paper. Firms have been reviewing the new IRS Form 1099-B (first and second issue), the new W-9 and the new Schedule D and Form 8949. When instructions are being made available they are being reviewed too. Firms are dealing with challenges caused by calculating wash sale holding periods, wash sale volumes, revising lot relief choices on a real-time basis, preventing lot selections after settlement date, continuing to educate customers and staff, calculating realized and unrealized gain or loss on gifted positions, crafting internal procedures for all of the new cost basis processes and trying to grasp the difference between a RIC that is or isn't a UIT. There are so many challenges and gaps that are apparent and many that are potentially being overlooked. And all of these implementation challenges are occurring in an environment where penalty relief under the Notice 2010-67 will end and the new tax reporting penalty schedule that was enacted in September 2010 will be effective. That law significantly increased penalties on Form 1099-Bs, transfer statements and issuer corporate action statements. These increased penalties are imposed if a firm fails to provide these forms and statements in a timely manner or if it fails to calculate cost basis correctly. The penalties start at \$100 per occurrence (incorrect or late 1099-B) and can climb into the millions of dollars.

The final question of the FIF Survey polled participants for their thoughts on ways to reduce the workload or facilitate the implementation for their firm or the industry in order to be compliant in 2012. Implementing Industry projects such as Options Symbology Initiative (OSI) in the past and now Cost Basis have raised the common themes of fewer resources, not enough subject matter experts, additional testing time required, a need for establishing two way communication channels with the regulators and the need to obtain final regulations/guidance in a timely manner.

Conclusion

This paper has presented some of the current issues the Industry is dealing with as it implements Cost Basis Reporting. Experience gathered from industry events, seminars, consulting and other sources of professional interactions has painted a portrait of differing views and interpretations. However, it is clear that there is a need for much greater training both for personnel and customers. More significant

customer involvement now would reduce the amount of confusion come tax reporting time. As the FIF Survey indicated, the challenges of Cost Basis Reporting are not subsiding but only simmering as phases two and three approach. Industry players have been meeting the challenges based on what is most important to their firms, but even so, there is still a need to resolve outstanding matters and to meet the expected demands that lie ahead.

Our Solution

To assist your firm in succeeding with its current and future implementation strategies, Jordan & Jordan can bring its extensive cost basis experience to “field test” and identify areas in need of remediation. Jordan & Jordan will pinpoint the gaps and issues that need attention now, and alert you to potential pitfalls awaiting you in phases two and three. For a truly in-depth look at your firm’s performance to date in cost basis reporting, Jordan & Jordan has constructed a 7-Point Compliance Audit Program. Using our template-driven methodology, we examine the critical areas of your company that have been impacted by cost basis to identify the pot holes and smooth the road ahead. Jordan & Jordan will assist in the effort to assure current compliance, mitigate risks of penalties and enhance your customers’ experience.

For additional assistance in preparing for 2012 and 2013, Jordan & Jordan can provide Subject Matter Experts, Project Management or education/training. Through the application of our cost basis expertise we can prepare your firm and systems for the handling of mutual funds, DRPs, Options and Fixed-income instruments. We can develop requirements documentation and/or testing strategies, as well as create the necessary procedures to implement cost basis reporting for these instruments. Along with this we also apply our understanding of the specific regulations to assure that your firm is complying with its systems as well as its personnel and processes.

For details regarding the 7-Point Compliance Audit Program, help with 2012 and 2013 compliance or for a copy of the whitepaper, contact:

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