



DAILY TAX REPORT



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The Truth About Cost-Basis Reporting: You're Not as Ready as You Think

BY SARA BRADY

Securities industry professionals may now be hearing more about cost-basis reporting legislation, enacted into law in November 2008 through the passing of the Emergency Economic Stabilization Act (Pub. L. No. 110-343); hopefully, your firm has assessed the impact that the new law will have on its operations and has begun preparing to meet the requirements that become effective Jan. 1, 2011.

For those that have not, however, you may be surprised to know that cost-basis reporting will require a significant amount of adjustments on the part of your firm, even if you already have a system in place to track cost basis. It is not a matter of if there will be an impact, rather how broad the impact will be to your firm, and with less than nine months left to prepare for the changes, readiness is approaching urgency.

Many firms will be spending significant amounts of money to prepare for the upcoming changes, but the surprising amount of capital it will take to be fully prepared speaks to the sweeping impact cost-basis reporting will have on all business processes. Consider other major initiatives that have affected the industry in the past and the information technology spend associated with regulations and hard deadlines. Make no mistake—cost-basis reporting is already shaping up to be the financial industry's modern-day Y2K, with a price tag to match.

The Securities Industry and Financial Markets Association (SIFMA) estimated that our industry spent be-

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tween \$4 billion and \$6 billion on Y2K preparation.¹ Decimalization set the securities industry back \$1 billion² and the Options Symbolology Initiative (OSI) another \$400 million.³ The business and operations remediation that will be needed to comply with the cost-basis regulations will more than likely fall somewhere between OSI and Y2K. Countless hours will be needed to educate investors and brokerage personnel about the new changes, complete testing before the cutoff date, and handle customers once the changes come into effect.

Couple these cost factors with the fact that the final regulations have not yet been published—it will be a few months before this happens and some significant changes to the proposed rules (REG-101896-09) may occur—and the Jan. 1, 2011, deadline looms ominously.

Failure to prepare for compliance by this hard cutoff date may result in hefty penalties, particularly if non-compliance is determined to be willful. Whether the Internal Revenue Service will consider the filing of incorrect information returns arising from inadequate preparation willful or not remains to be seen.

¹ SIFMA.org, "Testimony of Donald Kittell, Executive Vice President, Securities Industry Association Before the Senate Special Committee on Year 2000, September 17, 1998," <http://www.sifma.org/legislative/testimony/archives/Kittell9-17-98.html>.

² InformationWeek.com, "Wall Street Goes Decimal," Oct. 16, 2000, <http://www.informationweek.com/808/decimal4.htm;jsessionid=XHTTUR43EEX2NQE1GHOSKH WATMY32JVN>.

³ Financial Information Forum, "FIF OSI Post Mortem and Comparison to Cost Basis Survey Report," April 6, 2010, http://www.fif.com/survey/fif_osi_costbasis_surveyreport2010_request.php.

Current Functionality Supported	Custodians	Broker/ Dealers	Service Bureaus	Transfer Agents
FIFO	50%	79%	83%	13%
Average Cost	50%	53%	83%	38%
Other	50%	53%	67%	13%
Client currently has ability to make changes	0%	42%	83%	0%

Copyright Financial Information Forum (FIF), "FIF Cost-Basis Survey Report."

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The scope of cost-basis reporting requirements extends well beyond the original expectations of the industry, and a lack of preparedness due to an underestimation of the overall impact could result in customer disruptions as well as IRS penalties. To stay ahead of the compliance curve with cost-basis reporting, it is important to know how the new legislation will impact your firm inside and out.

What You Already Know

Beginning January 2011, firms currently responsible for producing Forms 1099-B must include the gross proceeds of the sale, the customer's adjusted cost basis, and indicate whether the difference represents a long-term or short-term gain or loss. IRS will then match firms' reported numbers with investors' returns, with misreporting resulting in penalties.

The phased implementation schedule for securities covered under the cost-basis reporting rules is as follows:

- equities—January 2011;
- mutual funds and dividend reinvestment plans—January 2012; and
- fixed income, options, and other instruments—January 2013.

What You May Not Know

Transfer reporting is a significant component of the regulations as well, requiring accurate cost-basis information to be passed from one broker to another when securities are transferred, whether due to account movement or securities being gifted or inherited.

Additionally, transfer reporting will expand the scope of "broker" to include "applicable persons," which may include such diverse individuals as transfer agents, custodians, wealth managers, private banks, and issuers, or their stock plan administrators.

For firms that do not currently participate in the Automated Customer Account Transfer Service Cost-Basis Reporting Service (CBRS), or those that do that receive

in physical transfers of securities, supporting the transfer of stock outside of the CBRS will be a significant project, as this will create a manually intensive work environment that will need specific policies, procedures, and documentation to protect the firm.

Of course, there are firms that have cost-basis accounting systems and procedures in place already; however, in their current state they are inadequate to meet the new requirements mandated by the legislation. Even firms that currently support cost-basis accounting will need to make significant changes to meet the new IRS directives. A Financial Information Forum survey demonstrated that while a good majority of firms currently have some level of cost-basis accounting support, only 21 percent of broker/dealers support wash sales and only 37 percent can support post year-end re-classifications for corrected gain/loss reports.⁴

Perhaps even more serious is the fact that the industry does not yet have the finalized rules in front of it in order to assess its readiness, and it is a real probability that the final regulations will differ from the proposed version. In a best-case scenario the changes will only be slight, but everyone must be prepared for substantial variation—and face an increasingly smaller window in which to accomplish the system and procedural changes necessary to comply.

The proposed rules also mandate that customers can select the lot relief method brokers use when determining gain or loss on a sale, thereby permitting them to choose a method that is different from a broker's default. Brokers must accommodate multiple calculation methods according to customer preference, including first in, first out, average cost, specific tax lot selection, and variations on specific identification including last in, first out.

In order to be in compliance, a firm will be required to handle all tax lot relief methods allowed by IRS. Different calculation methods can be applied to different security types within the same account, and even to identical securities in the same account, and brokers will have to support these functionalities as well. As the FIF survey results, shown in the accompanying table, demonstrate, firms that currently support some functionality will, at the very least, need to expand their offerings.

The extent of these changes is not limited to year-end tax processing systems, as cost-basis systems both old and new will need to be brought up to speed to properly integrate with back office processing, industry utilities, and front-end systems. An overwhelming 79 percent of

⁴ Financial Information Forum (FIF), "FIF Cost-Basis Survey Report," <http://www.fif.com/>.

firms surveyed indicated that they are planning a complete in-house or hybrid solution⁶; integration of third-party systems with many in-house processes, as well as any internal solution, will require extensive coordination. Internal training, client education, and documentation are imperative.

The back office will be greatly impacted by the new regulations—tracking, transferring, reporting, and presenting cost-basis data will require unprecedented accuracy. Once the initial conversion to a more robust cost-basis system is completed, adjustments will be needed in the future as additional instruments are phased into implementation and other activities resulting from trading activity, stock splits, and mergers occur. Scalability and growth factors for any given solution will also be an ongoing consideration as the market continues to evolve after cost-basis implementation.

The effort on the part of the industry to prepare for the new regulations is extensive and looming. The implementation date for equities in 2011 will not be changed or delayed. An act of Congress, EESA, dictated this plan and tasked IRS with its implementation, and IRS has made it clear to FIF that only Congress can provide relief from this deadline.

At a Feb. 17 IRS hearing on the proposed regulations, the FIF Cost-Basis Working Group co-chairs Brian Godfrey, of Charles Schwab, and Martin Bentsen, of Computer Research Inc., requested that IRS provide greater leniency on effective dates in the absence of final regulations. Godfrey stressed the importance of adoption of CBRS for transfers, due to inaccurate and corrupt data resulting from manual methods, and how much time and industry coordination is needed for such a small percentage of accounts.⁷ He also touched upon significant system challenges for gifts and inherited securities, while Bentsen talked about short sales issues, with firms needing to collect information effective Jan. 1, 2011, and the differences in the manner brokers and taxpayers will track and maintain cost basis for wash sales.

Despite the urgency of the requests voiced at the hearing, IRS made it perfectly clear that it lacks the capacity to delay the effective dates without congressional intervention.

⁶ The Financial Information Forum, "FIF Cost-Basis Survey Report."

⁷ The accounts to which Brian Godfrey is referring comprise only 3 percent of all accounts.

What You Need to Know

The new cost-basis requirements demand expansive data collection, maintenance, and processing capabilities. The effort that rests on the shoulders of brokerage firms, transfer agents, custodians, wealth managers, private banks, issuers, and stock plan administrators is significant.

Firms must create new client communications and documentation procedures to provide clients with the ability to elect and change lot selection methods at any time, as well as differentiate the processing of covered and uncovered securities, Dividend Reinvestment Plans (DRPs), and non-DRPs.

IRS Form 1099-B reporting formats will need to be updated for compliance, and will need to include reporting on wash sales, updated timing of short sale reporting, and backup withholding. Firms must be able to send, receive, and correct cost-basis information on transferred securities in both electronic and manual formats.

Back-office systems must be able to track corporate actions to adjust cost basis on current client positions, even on positions that have since been transferred. Once implementation for equities is complete, these systems must be ready to make adjustments for mutual funds, DRPs, options, and fixed income while remaining dynamic enough to accommodate the implementation of other security types and rule changes in the future.

Client servicing under the new reporting system will also change, impacting the relationship between brokers and their clients. Even though clients will have selected their preferred cost-basis methodology, they will be permitted to change their election for most transactions at any time up to settlement date. In light of this and the complexities arising from wash sales and other new cost-basis reporting tracking requirements, clients may find it challenging to match their Schedule D filings with brokers' Form 1099-B information reporting to IRS. Those challenges will quickly become customer service challenges to brokers.

A deep understanding of the implications of cost-basis reporting and its impact on a diverse set of circumstances is necessary to provide a solid and practical plan for process review, impact and risk analysis, and a recommended course of action. Cost-basis reporting will be not only extensive but unique to each firm.