

# Cost Basis Reporting

## Key Challenges

The cost basis reporting law, Section 403 of H.R. 1424 of the Emergency Economic Stabilization Act of 2008, requires brokers to provide detailed information regarding the cost basis of stock and securities to the IRS and to customers, beginning with stock acquired on or after January 1, 2011. There are a number of critical areas that brokers must address immediately to comply. Highlighted in this document are some of the key challenges that must be addressed in time to meet the initial effective date.

### Adjusting cost basis for wash sales

#### How will you handle the average 300% increase in data volume to track wash sale deferral tax 'sub-lots'?

Brokers must accurately adjust basis for wash sales. Further, to determine whether a transaction has created a wash sale deferral, brokers additionally will need to manage tax sub-lots. There will be a significant data volume increase due to the need to track the sub-lots.

Most systems are not equipped to process this significant increase in data volume. As a result, most brokerages are actively augmenting their existing technology through third party vendor solutions to accommodate this. To meet the initial effective date of this law, brokers must have systems in place capable of handling the significant increase in data volume associated with these wash sale calculations.

### Adjusting cost basis for corporate actions

#### How will you adjust for the full-range of corporate actions?

Brokers must adjust basis for the full-range of corporate actions. As the complexity of corporate actions increases, the difficulty in accurately calculating the effect on cost basis also increases. Brokers will also need to obtain the unique corporate action ID required under the proposed cost basis regulations. Although U.S. issuers will provide some of this information, to meet their reporting obligations, brokers will likely still need to track and review issuer corporate action information.

Each year there are more than one million corporate actions. Accounting for these is tedious, time-consuming and error-prone. Ideally, brokers will leverage real-time corporate actions data feeds and have access to experts for in-depth analysis and understanding these events.



## Securities Tax Solutions

### Providing cost basis for foreign stock

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#### How will you track corporate actions on foreign securities?

Since the cost basis reporting law does not carve out foreign securities, they must be accounted for to comply. The challenge of tracking basis adjustments intensifies when dealing with foreign issuers that use different event types under their own laws and accounting rules and may not report U.S. tax consequences. If foreign securities are held in the form of ADRs, there is an extra layer of complexity. Brokers must understand the details of the local event, and the elections the U.S. depository made, in order to understand how to treat proceeds and other distributions paid to U.S. holders.

It is essential that brokers have access to accurate foreign securities corporate actions information to accurately calculate basis. Optimally, brokers will align with corporate actions experts for analysis and data feeds to ensure accurate booking of corporate actions for foreign securities.

### Providing cost basis to brokers when securities are transferred (transfer reporting)

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#### How will you handle account transfer cost basis reporting?

The law obligates a transferring broker to furnish a receiving broker with information necessary for cost basis reporting within 15 days of the transfer, per Code Section 6045A(c). A particular concern under cost basis reporting relates to transfers of customer accounts from one broker to another, as currently there is no standard transfer statement and brokers will be subject to potential IRS penalties relating to incorrect or late statements. Additionally, failure to correctly report basis on transferred accounts could result in customer service issues.

Brokers will need to develop systems that generate the statements required to meet their obligation when a customer transfers his or her account to another broker on time. Therefore, a broker's cost basis information must be readily accessible throughout the year in order to permit the broker to comply with this statement requirement. For brokers of almost any size, their systems should probably accommodate daily account transfers.

### Tracking and reviewing issuer corporate action information

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#### Where will you find issuer corporate actions reporting information?

Issuers of specified securities are also subject to new tax return obligations under the cost basis reporting law in connection with corporate actions under new Code Section 6045B. This requires issuers of securities to provide customers or their nominees with a statement that includes tax information detailing the effect of a corporate action on the investor's basis in his or her security no later than 45 days after the date of the corporate action or January 15th of the following year (if earlier).

The cost basis reporting law does not provide many details of this new corporate action statement requirement, and brokers will bear the burden of processing such statements. Therefore, brokers will need close to real-time access to issuer corporate action information and will need to continuously monitor it. Optimally, issuer statements will be available from a readily accessible source in a consistent format.

### Educating and explaining cost basis information to customers

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#### How will you manage the anticipated spike in customer service costs?

Recently, TowerGroup conducted an industry survey in which 85% of the financial services institutions polled believed that they would spend less than \$1 million (USD) on cost basis customer service annually<sup>1</sup>. In another outreach, Securities Industry News noted that more than 27% of firms that they polled anticipate 10 or more full-time employees dedicated to basis reporting customer service calls<sup>2</sup>.

However, given the complexities of explaining these challenges, these estimates are likely low. The vendors contacted by Securities Industry News unanimously said they are hiring project managers and other staff to accommodate the anticipated rush. They all acknowledged the likelihood that latecomers may be unable to implement and test systems by the start of the year.

Although intermittently offered by some brokers, in general, cost basis has not been reported on the 1099 form. The novelty alone will likely spike customer inquires. Additionally, since

customers will learn that the cost basis is also being reported to the IRS, there is potential for confusion around what this means that will likely result in a greater volume of calls to broker customer service centers. Further, as brokers only need to report basis for covered securities, listing both covered with basis, and noncovered without, will likely create a call surge for explanations. Finally, as the law calls for increased reporting flexibility, (such as tracking all allowable tax lot relief methods), as this has never been offered previously, it will likely also increase customer confusion and related inquires to advisors and service centers.

Financial services institutions must develop and execute comprehensive client communication plans in 2010 to educate clients fully in 2011 on cost basis reporting to minimize customer confusion and contain associated customer support costs. Further, such a plan should include communications when 2011 reporting materials are sent to clients in 2012.

Explaining the cost basis of historical, noncovered securities holdings

**How will you explain the difference of covered versus noncovered securities? What are the streamline options for this process?**

Another facet of client communications is the challenge explaining why basis is shown for some covered securities holdings, but not for other noncovered securities holdings. As stated previously, this will likely create a call surge for explanations, with steep increases in associated customer service costs.

Brokers can ramp up customer service personnel in advance and outreach to clients well ahead of the initial effective date. As an alternative, brokers could additionally provide basis for noncovered securities with associated customer communications and potentially minimize the surge in service calls. The simplest method to address this would be access to a batch basis service that could efficiently calculate pre-effective date basis. This would be a value add feature that can ultimately reduce support costs.

**Failure to successfully meet these challenges can result in regulatory tax penalties, dissatisfied customers and competitive disadvantages.**

There is a significant tax penalty risk if the basis and holding period information reported on Form 1099-B is incorrect. There are separate penalties for 1099s provided to the IRS and 1099s provided to taxpayers, and they aggregate to \$100 per incorrect 1099 (with an annual maximum of \$350,000 per year before interest). If the error is due to intentional disregard, including a demonstrated lack of due diligence to comply, the combined penalties are 10 percent of the amount that should have been reported (without any maximum limit). Further, bills have already been introduced to Congress that would increase these penalties.

To be compliant with the cost basis reporting law by the January 1, 2011 initial effective date, brokers must have a preparedness plan in place or face significant financial and reputation consequences.

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<sup>1</sup> Hidden Cost of Cost Basis Reporting: (1099s x Confused Clients) + Phone calls = \$\$\$, Tower Group January 11th, 2010

<sup>2</sup> Y2K Plus 10? Cost Basis Rules Producing Technical Jitters, John Hintze, Securities Industries News, March 8, 2010

## Your Cost Basis Reporting Compliance Partner

Wolters Kluwer Financial Services provides a unique, comprehensive suite of offerings facilitating compliance with the cost basis reporting law. Whether you need a cost basis reporting enterprise compliance solution, core modules, such as batch wash sale calculations, a detailed understanding of the tax consequences of U.S. and international corporate actions or automated access to historic cost basis to serve as a batch data source for interim compliance, to cross-check your basis or to minimize customer confusion on noncovered securities, you can count on Wolters Kluwer Financial Services for unparalleled tax and technology expertise to help you accurately and efficiently comply with the new cost basis reporting rules.

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- A sophisticated tax-centric technology team with close to a century of tax lot accounting experience.



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