



FINANCIAL SERVICES

# Cost-Basis Reporting: a Customer Service Opportunity

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It is rare for a tax code revision to be so all-encompassing, but every investor receiving Forms 1099 in connection with a sale or redemption of equities, mutual fund or DRIP shares, or options or fixed income securities will be affected by the changes to cost-basis reporting.

The passage of the *Emergency Economic Stabilization Act of 2008* (the Act) ushered in a new era for broker reporting requirements. With new rules embedded in the Act, mandatory information reporting to the Internal Revenue Service (IRS) on Form 1099 will include not only gross proceeds but also the adjusted cost basis for securities sold and whether the related gain or loss is short- or long-term. Embedded within the rules are numerous details surrounding such considerations as treatment of wash sales, S corporations, and “organizational actions.”

These new rules have staggered effective dates and will apply to:

- Equities acquired on or after January 1, 2011
- Mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012
- All other financial instruments, including fixed income securities and derivatives, acquired on or after January 1, 2013.

Certainly, cost-basis reporting (CBR) is not new. In fact, many financial entities already provide some elements of this information on a voluntary basis. However, even these entities could find the nuances of the mandatory environment to be far-reaching and complex. While voluntary information may now be made available to customers, in the future it must be provided to both customers and the IRS. In addition, in

the voluntary world, brokers can decide what methodology to apply when making cost-basis information available to their customers. Going forward, however, customers may notify their broker of their preferred cost basis reporting methodology, potentially requesting a methodology not previously supported by the broker. Moreover, only a narrow band of customers currently receive a complete picture of the cost-basis. Any shares acquired by gift or inheritance or transferred from one financial intermediary to another typically have not been included due to a lack of historic information — but that will no longer be the case.

It is rare for a tax code revision to be so all-encompassing, but every investor receiving Forms 1099 in connection with a sale or redemption of equities, mutual fund or DRIP shares, or options or fixed income securities will notice these changes. For some financial entities, the affected customer base literally will be in the millions. With this revision, mere compliance with the new requirements may not be enough. There is ample room for customer confusion if the changes are not implemented and communicated well, and companies will want to avoid the reputational risks and loss of trust that could arise. In contrast, those companies that handle the transition smoothly have the opportunity to turn a compliance requirement into a potential competitive advantage.



## Cost-Basis Reporting Challenges

There is still considerable uncertainty regarding the detailed regulatory requirements. While details such as acceptable means of soliciting customer methodology preferences; formatting of amended Form 1099, Schedule D, and Form W-9; and penalties for noncompliance continue to be debated, numerous challenges are already apparent.

### Business Requirements

Each entity has its own business model for meeting its tax reporting obligations. Based on the existing model relative to the overarching goals of the new requirements, consideration should be given to:

- Data storage and transfer requirements
- System changes and updates, e.g., the ability to process wash sales, along with system integration issues
- Project management
- Customer service requirements, including communication and education
- Support for multiple cost-basis reporting methodologies

### Vendor Relationships

For those entities that work with a vendor to handle information reporting, decision points exist relative to:

- Implementation plans, including monitoring of progress
- Testing procedures, including parallel tests
- Roles and responsibilities at the vendor versus at the entity level

Regardless of the authority given to a vendor to implement the new requirements, the financial entity often retains the customer relationship and the ultimate responsibility for accurate reporting. Thus, the potential consequences of poor implementation — from IRS penalties to bad press to loss of public confidence — revert to the financial entity.

### Distribution Channels

Different challenges can arise depending on the form of distribution channel in use, as the customer relationship and interaction vary greatly depending on the channel.

For financial entities that market directly to the consumer, considerations surround:

- Customer education
- Management of the customer expectations surrounding the changes
- Solicitation of preferred cost-basis reporting methodologies
- Customer-driven demands for similar cost-basis information related to securities purchased *prior* to the effective dates of the new CBR requirements

Those who use registered investment advisers (RIA) will potentially face the challenges noted for financial entities that market directly to the consumer with respect to the underlying clients of the RIA, as well as the following:

- Migration of RIA client data onto the financial entity's platform
- Education of the RIA workforce
- Buy-in on the need for CBR quality control

When third-party distributors that retain the underlying customer relationship are





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used, the focus shifts; however, even in these cases, financial entities will need to take into account:

- Relevant data elements that will be requested by the third-party distributor
- Data storage and transfer requirements

#### Customer Mobility

Financial entities will need to be able to receive and send cost-basis reporting security data at the lot level, to help ensure that reporting includes the full universe of each customer's investments. Challenges surrounding mobility include:

- Data storage
- Transfer requirements
- Use of industry protocols, such as Depository Trust Clearing Corporation (DTCC) applications or other, as yet undetermined, means

#### Moving Forward

Notwithstanding the uncertainty surrounding the final regulatory requirements, companies can be making

decisions and taking steps now to help prepare for the coming changes.

Given each entity's unique characteristics, perhaps the most important step at this time is to gain an understanding of which operations could be most affected. With such an understanding, one can consider the critical paths necessary to effect changes and updates to existing systems, processes, and resources. For example, if certain cost-basis reporting methodologies are currently not in use, actions can be taken to support these methodologies going forward. Entities can begin making decisions on the preferred means of soliciting information on customer methodology selections, whether through an "opt-in" or "opt-out" query, and whether through a Web-based application, account statement messaging, direct shareholder letters, or some other medium. Such decisions can then guide implementation activities, including the use of in-house or third-party applications.

Education will also be key, whether it is for the workforce or directly for investors. An RIA workforce may require in-person



training seminars or Web-based sessions, while customers may want access to literature and Websites. A decision point should include how much education to provide directly to investors prior to the changes going into effect. Customer service call centers, with sufficient staff to help address what will likely be increased call volume, should be in place prior to the effective date of the changes. These staff members may also need training to appropriately respond to customer inquiries.

Existing vendor relationships should be examined to determine how to jointly achieve compliance with the rules. Understanding and agreeing upon roles and responsibilities both in-house and at the vendor will help ensure that efforts are not duplicative and that everyone is working toward the same implementation goals.

With the staggered effective dates associated with the new rules, these undertakings will be a multiyear effort. Since the IRS has not yet finalized the details, “work-arounds” may well be necessary, particularly for those with reporting requirements subject to the

2011 effective date. However, companies should proactively consider the potential long-term implications on the front end with the goal of minimizing disruptions and customer dissatisfaction over the transition period.

### Conclusion

The new world of cost-basis reporting will not be “business-as-usual.” Rather, the nuances surrounding implementation quickly add up and touch numerous operations. Even those entities that practice cost-basis reporting on a voluntary basis or who rely on third-party vendors will not be immune from the challenges.

It is not too soon to begin taking action, especially for those reporting requirements with an effective date of 2011 — workplans, staffing, and budgets should be in place as soon as practicable to help allow sufficient time to meet the deadline.

The price for noncompliance may very well be measured in more than

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just IRS penalties. With requirements that are highly transparent — and yet somewhat confusing — for investors, those companies that take their customer relationships lightly could face a diminished reputation in a highly competitive environment. On the other hand, those who can be proactive at considering the possible consequences may well find competitive advantage in this complex tax reporting provision.

### About the Authors

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### Contributors

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