

THE COMPLEXITY OF COST BASIS REPORTING

HOW IS YOUR SERVICE PROVIDER
MANAGING THE ISSUES SURROUNDING
COST BASIS REPORTING?



THOMSON REUTERS

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Introduction

New legislations can be complex and therefore confusing. This white paper highlights how the Emergency Economic Stabilization Act has impacted the way we have to look at cost basis reporting. We'll take a look at how Thomson Reuters BETA Systems, Thomson Reuters back office brokerage processing system, is preparing for the issues that arise with the passing of such acts. Taking the appropriate business and technology steps now can help you greatly in the future.

The Act

When Congress passed the Emergency Economic Stabilization Act of 2008 ("the Act") in October 2008, it not only provided the US Government with the ability to purchase troubled assets, it also legalized a concept that has been discussed for years but never acted upon – the concept of mandating accurate cost basis as part of the tax reporting environment.

As a result of the passage of the Act, the financial community was immediately faced with two fundamental questions:

- What does this mean to my business?
- What does this mean for our information technology, financial services, and data processing platforms?

The financial industry as a whole -- broker/dealers, mutual fund managers, transfer agents, service providers-- is currently operating in a "wait and see" mode, anticipating some initial guidance from the IRS as to how the Act will be enforced. The perceived impacts are tremendous, both to the business practices and the technology platforms. They range from account opening to trading, to customer statements and confirms, and just about everything in between. The problem is that we know enough to be concerned, but not enough to start investing in long-term solutions.

Business Challenges

Let's discuss some of the major topics that are important to the financial services industry and present the most significant challenges. This focuses on some of the potential obstacles. Readers should be diligent in their research and planning and should look to tax professionals as well as the IRS for further guidance and interpretations.

Cost Basis Default Election

Brokers will need to insure that customers – both new and existing – are fully aware of the firm's default cost basis methodology, their right to select a different method, and how that decision will impact their overall accounts. In addition, the brokers will need the ability to efficiently manage client requests to change their basis methodology. Impacted areas will include, but are not limited to, new account forms, account recertification processes, disclosures, and other informational messages on client-facing internet applications (including online trading).

Proper Identification of a "Covered" Security

For purposes of this discussion, the term "covered" refers to when the various investment instruments will become subject to 1099 cost basis reporting requirements. As it stands now, the legislation has identified three phases: year 2011, for stock in a corporation; year 2012, for securities eligible for average cost accounting; and year 2013 or later, for all other securities as determined by the Secretary of the Treasury. Based on this information, broker/dealers will need the ability to clearly identify what is covered versus uncovered and comply with the reporting requirements accordingly. This will impact nearly every aspect of daily broker/dealer operations, from ACATS transfers to 1099 reporting. In addition, this could lead to numerous opportunities for efficiency changes within the back office or middle office processing environment to segregate daily exceptions so covered securities can be given a higher priority.

Proper Reporting for Transfer of Assets

Any entity that takes possession of a security on behalf of an investor during the transfer process is going to be required to pass along cost basis information. There are numerous challenges associated with this single requirement: efficiently transferring the data --for firms that do not participate in the ACATS Cost Basis Reporting Service (CBRS), identifying the proper tax lots for a partial transfer of an account, tracking and applying corporate actions for positions that are in transit, obtaining cost basis

when it isn't readily available, and passing the basis to the receiving broker within a reasonable time frame. These challenges will garner a tremendous amount of attention, both from a systems development perspective and from an industry testing perspective.

Dividend Reinvestment Plans (DRIPs)

This topic seems to have generated a lot of buzz across the industry, and there are many questions surrounding it. The most basic is one that has not yet been clearly addressed: "What qualifies as a DRIP?" The criticality of this question is enormous. The answer will determine what phase, or time period, the proper accounting rules take effect (2011 vs. 2012), what cost methodology is allowed (average cost vs. FIFO vs. specified lot), and how subsequent additions (by way of transfer or direct purchase) will impact the cost basis accounting.

Some will maintain that mutual fund reinvestment programs should be subject to the DRIP scrutiny. Others believe that any sponsored reinvestment plan – mutual fund or brokerage sponsored equity plans – should qualify. There is also the concept of a single or bifurcated accounting method, which in its purist form would require broker/dealers to separate pre-effective date lots from post-effective date lots when computing average cost.

Post Year-End Reclassifications (Return of Capital (ROC), Undistributed Capital Gains)

Under the current operating model, most, if not all, broker/dealers properly account for situations in which registered investment companies (RICs) declare an income reclassification after year-end. Most properly capture the information for tax reporting purposes. However, few of the broker/dealers apply the income reclassification to the tax lots. Under the new legislation, this will be a requirement. This presents a couple of challenges. First, there needs to be a defined cut-off for when the RICs can declare the income reclassifications; otherwise the broker/dealer will be in a constant cycle of adjustments and 1099 corrections. Second, the broker/dealers need to have an efficient way to update the underlying tax lots for the open and closed positions.

Ability to Reconcile Client Reporting Against Broker/Dealer Reporting

While it may sound simple and straightforward, this topic presents enormous challenges, primarily in the areas of human resources and technology. Broker/dealers will need to plan for the possibility of needing additional staff during tax reporting season to address the flood of client questions they are likely to receive. Clients will most certainly have questions about wash sale adjustments and other adjustments that they may not have factored into their cost basis when they reported on Schedule D, and the brokers will need to help them reconcile the differences. To do this, they will need a way of identifying all of the

adjustments that occurred while the tax lot was open, and have access to that data for two or three years after the tax lot is closed. This presents a clear technology challenge. The amount of data that will need to be stored is projected to be in the billions of records. Low-cost storage platforms and efficient user interfaces to retrieve this data will be at a premium.

Integration and Required Reconciliation of Cost Basis System with Tax Reporting System

The new legislation will require cost basis accounting and tax reporting systems to have a symbiotic relationship. This is a significant culture shock to both the business and technology sides of the industry and will present equal challenges to both. Firms will need to constantly remind themselves that one area will now impact the other, and the technology solutions put in place will need to do the same.

Technology Challenges

In the IT world, it is common knowledge that every business challenge will be accompanied by a technical challenge. The business challenges presented by the Act are no different. Below are some of the primary technical challenges that we foresee the industry will be facing. It will be crucial for broker/dealers to partner with a technology provider – either internally or externally – that can prove that they are ready to take on and address these issues.

Increased Data Storage Requirements

As discussed earlier, one of the most important business requirements of the new legislation will be reconciliation between client cost basis reporting and broker/dealer reporting. We anticipate that this will require storage of billions and billions of records. It will also put significant pressure on the technology platform's ability to store the data in a cost effective manner and still allow efficient and timely data processing and end-user access to the data.

Increased User Demand for Timely, Accurate Cost Basis Information

As cost basis accounting becomes more mainstream, there will be a natural increase in demand for the data. Brokerage systems will need access to this data more than ever before. Instead of just an "add on" for the higher net worth clients, Cost basis information will become an integral part of the overall brokerage solution. Across the board, brokers, middle office, and back office personnel will need timely, accurate data. This means that everything will be impacted, from the primary securities processing system all the way to the broker desktop.

Third party vendors will also have an increased appetite for this information. Performance reporting solutions, client confirms, client statements, and

business process management solutions will all require access to this data in unprecedented ways and volumes. Technology platforms must be able to meet this increased demand as well as be scalable and flexible to adapt to ever-changing requirements.

Data Integrity, Accuracy, and Reliability

If cost basis information is a requirement for IRS reporting, the underlying data must be accurate and reliable. Processing systems must have the proven ability to accommodate the various types of cost basis adjustments (specific lot identification, capital changes, cost adjustments for amortization and accretion, option premiums, etc.), and do so efficiently and with a high degree of accuracy. In addition, systems must be flexible enough to allow each broker/dealer to determine who can update cost basis information based on their individual business practices and policies.

Systems Integration

Having a cost basis accounting solution that is integrated with the core brokerage platform will be more important than ever. Systems will need to integrate trading, capital changes, reorganization announcements, tax reporting, and client statements. Firms will benefit from a platform that can provide a single source of data that is easily consumable by third party vendors who supplement their business models. The single source of data ensures that it is consistent from one application to the next, and that the end client receives clear, consistent output, no matter how they get it. The greater the reliance firms have on outside platforms to perform core cost basis accounting, the more reconciliation they will need to perform to make sure the data is accurate and reliable as it travels through the broker/dealer continuum.

In Closing

At Thomson Reuters we are addressing many of these concerns right now, and developing plans to address any unknowns in the future. We offer an integrated brokerage processing solution, Thomson Reuters BETA Systems, that includes cost basis accounting as part of its core and are working with our broker/dealer clients to identify potential system modifications as the cost basis landscape changes. We are working with our subject matter experts – both in the tax lot accounting and the tax reporting areas – to obtain as much business intelligence beforehand as possible from our various industry sources. We are planning our technology and data processing strategy to put us in the best position possible to handle the IT challenges coming our way. We are developing architectural plans that include mainframe database solutions as well as distributed solutions to provide us with the flexibility and cost effective solutions we feel will be required to properly service our customers.

We are taking action.

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