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Setting the Stage for January 1, 2011: How To Avoid A Return To The Manual Processing of Yesteryear

Few moments in tax code history are as dramatic and full of impact as the new cost basis reporting regulations:

While Section 403 of Division B of Public Law 110-343 details the legislation, the bottom line is this:

- Cost basis reporting will be made mandatory for all brokers executing transactions that involve publicly traded securities.
- January 1, 2011 is the deadline for the requirements to report realized gain/loss information to the IRS for the benefit of clients who have purchased equities. Other deadlines on mutual funds and other securities follow in 2012 and 2013.

For some financial entities, the affected customer base will likely 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. Companies will want to avoid the potential loss of trust that could arise from miscommunication. In contrast, those companies that handle the transition smoothly have the opportunity to turn a compliance requirement into a potential competitive advantage.

While the IRS has come out with final regulations, some uncertainty remains. How can you help your clients handle potential issues

like these from an operations and systems perspective?

- **Countdown to contradiction**
As currently proposed by the IRS, cost basis tax lot transfers must be completed within 15 days of the share transfer between reporting brokers, or the delivering party could face IRS penalties. Technically, lots sent after 15 days can be considered as non-covered, for cost basis reporting purposes, by the receiving broker – a delay that runs counter to the IRS' desire to move cost basis information on an in-kind basis as qualified legal ownership transfers between reporting brokers.

- **A return to the manual transfers of yesterday**
While automated capabilities are planned through a link between DTCC's Cost Basis Reporting Service (CBRS) and both ACATS-Fund/SERV and Networking, CBRS will only be effective if both the delivering and receiving parties support the utility. Manual cost basis transfers stand a real chance of being the major operational method, however, if either side of the transfer cannot be supported by automation. The picture seems like a return to the pre-automation days, when the delivering party would print out cost basis information to send to the receiving party, who then manually key-stroked the data into their record keeping system.

Imagine that last scenario playing out hundreds or thousands of times each month. A new cost basis data entry cottage industry could emerge overnight. Document retention and data entry quality might then expand the manual environment further. What would be the result of all of this handwork? It's probable that in a slower environment the lots would trail these manual activities by days, if not weeks.

Ironically, brokers could be in a manual environment not because of their preparedness, but the lack of preparedness of their business partners (on the other side of a transaction). The only way to avoid this "go slow" approach is for the investment management industry to thoroughly embrace automation and uniformly adopt tools like CBRS to manage the volume.

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