



COST BASIS — TURNING  
COMPLIANCE INTO AN  
OPPORTUNITY TO IMPROVE  
YOUR BUSINESS

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In 2005, the Internal Revenue Service (IRS) attributed the tax gap for 2001 to taxpayers misreporting \$11 billion worth of capital gains or losses. The Government Accountability Office (GAO) was asked to analyze the misreporting and the actions the IRS takes and to suggest ways to improve taxpayer compliance. The GAO ultimately recommended that brokers be required to report cost basis information to the IRS.

Historically, firms reported only the gross proceeds from sales of securities on behalf of their clients. However, the accuracy of a reported gain cannot be assured or confirmed if the investment's base starting point or cost is uncertain, unadjusted or unknown. And as any business or individual who has filed taxes knows, when it comes to tax revenues, accuracy and traceability are essential.

On Oct. 3, 2008, the U.S. Congress passed the Emergency Economic Stabilization Act of 2008, which was signed into law by President George W. Bush. Section 403 of Division B of the Act makes cost basis reporting mandatory for all brokers executing transactions that involve publicly traded securities.

Under this law, firms must track and report the cost basis of stocks, bonds, mutual funds and other securities, using choices that include the first-in, first-out method, specified lot processing, or the average cost method for mutual funds. Firms also need to specify whether gains are long-term or short-term and if the securities are covered or uncovered.

### COST BASIS REPORTING REGULATION IMPLEMENTATION SCHEDULE

Section 403 of Division B of Public Law 110-343 details the legislation that makes cost basis reporting mandatory for all brokers executing transactions that involve publicly traded securities. The requirements to report realized gain/loss information to the IRS for the benefit of clients have the following deadlines:

- January 1, 2011 — Equities purchased on 1/1/2011 or later
- January 1, 2012 — Mutual funds and DRIPs purchased on 1/1/2012 or later
- January 1, 2013 (or a date to be determined) — Fixed income options and any other securities that the IRS decides to include, purchased on 1/1/2013 or later

## UNDERSTANDING THE CONSEQUENCES OF NON-COMPLIANCE

Under the new law, cost basis information reporting is no longer considered "nice-to-have" or a value-added service on statements. Non-compliance carries penalties that can affect both the firm and the client. Failure to report accurate cost basis information could cost upwards of \$100 per Form 1099-B, with a maximum penalty per legal entity of \$350,000. Should a firm intentionally fail to report cost basis information, the fine increases to \$200 per 1099-B, or 10% of the amount that was required to be reported (whichever is greater). Moreover, in the case of intentional failure to report, the penalty that can be imposed is limitless.

## CONSIDERING THE OUTSTANDING QUESTIONS

Despite the looming deadline for compliance, several aspects of the law remain unclear. For example, while some industry groups believe that Congress intended to exempt gifted and inherited shares from cost basis reporting, the IRS included them in its guidance. Making the correct basis adjustments to coincide with gifts and date of death valuations with inheritance is the main challenge, especially on a jointly held account where it is unknown if one party has been deceased for years.

Firms also need to know how to deal with rules that vary or contrast across the 50 U.S. states and how to carry fair market value and gifted value — and then, based upon sale proceeds, determine which to use. In addition, guidance is needed on how to apply fair market value to a security when it is gifted, as well as the differences between individual gifts and charitable gifts.

Many industry participants submitted comment letters to the IRS in February 2010. These comment letters focused mainly on requests for additional guidance, particularly regarding:

- Transfer requirements
- Short sales
- Foreign securities
- Wash sales
- Average cost
- “Like” securities (including DRIPs)

The comment letters also asked for relief, since changes may not be written to the Federal Registry until June or July 2010 at the earliest.

Due to the lack of information, many firms are delaying their pursuit of compliance. By doing so, these organizations may not leave enough time to achieve full compliance. They may also miss the hidden opportunities presented by cost basis projects.

## RECOGNIZING THE OPPORTUNITIES

Cost basis reporting may look like just another item on the compliance agenda, but it actually presents brokers with the opportunity to create greater transparency, process efficiencies, streamlined IT infrastructure, and new business. As part of the compliance project, firms can re-examine how their clients are supported, look for ways to transform their IT environment, and discover new client and business prospects. Even as certain details of the regulation remain undecided, firms can tackle many issues now by concentrating on those that are within their sphere of influence, ownership and capability, such as customer service, systems and implementation, and internal education and training.

### **Strengthening Customer Service and Fostering Transparency**

Many firms are focusing their energy on the back-office aspects of cost basis reporting, but clients and the front-office need attention as well<sup>1</sup>. With the added complexity of cost basis rules, clients are going to need extensive help to understand the changes firms will be introducing. Confusion now may exist regarding 1099-B forms from their broker and what the information means to them. Questions may center on why some firms choose to report uncovered securities on 1099-B forms, yet others do not, and why some security types are showing, but others are not (e.g., equities for 2011, but other security types are not required until later). Clients need to know what covered versus uncovered means to them and how it — and other changes — may affect their reporting. Clients will turn to their advisors and tax professionals for answers.

While clients may proactively seek guidance and transparency from their advisors and accountants, firms need to communicate as well if they wish to avoid eroding client trust. Firms can help their clients understand the regulation, their obligations, and how all of their accounts and investments work together. Advisors should also be proactive in educating their clients on how the tax laws affect them, and the fact that they can choose how cost basis is maintained. This includes being able to have a standing order with their firm on their accounts for lot relief methodology (e.g., FIFO, LIFO, MIN or MAX gains and losses), as well as the ability to select average cost for those securities or transaction types that are eligible.

If this challenge is viewed through the lens of customer relations rather than compliance, then it becomes clear that this is an opportunity to strengthen existing relationships and foster transparency. Firms can also provide tax-planning services, perhaps by alerting clients to unrealized gains or simply delivering updates that are more frequent so that clients can better understand their overall financial performance.

### **Analyzing Current Operations**

Many organizations may already have some type of cost basis system in place<sup>2</sup>. Some systems may be limited to certain securities or situations, but even the broader ones may need modification due to fresh complexities introduced by the law, including new wash sale rules, the transfer of cost basis when clients move their securities from one industry participant to another, as well as the allocation and identification of tax lots and sub-lots. Not all firms have an adequate methodology for determining lots or allowing a client to specify lots or a default-lot relief choice.

Therefore, as with any major project, the first step is an operational assessment. This includes an in-depth process analysis to identify opportunities for efficiencies and pinpoint the organization's specific needs. Firms may choose to perform this analysis themselves through a formal internal audit or a continuous improvement program. Alternatively, they can partner with an organization that has expertise in the cost basis rules and their effects on financial services organizations.

The analysis should determine whether the existing technology:

- Delivers accurate cost basis information that is updated either intraday or via overnight batch process, when possible<sup>3</sup>
- Automates elements of the process, helping to increase productivity and reduce errors
- Handles multiple elements of the cost basis reporting process
- Stores tax lot data for both open and closed tax lots
- Coordinates with tax reporting systems
- Passes tax lot data throughout the industry between broker/dealers, banks, transfer agents, mutual fund companies, and issuers
- Identifies securities by product type and transaction type
- Meets record retention requirements
- Supports the desired level of customer service that is consistent with the firm's policies

Data is another key element. For example, since corporate action events can have a complex effect on cost basis calculations, firms need an accurate source of corporate action information and reliable technology to process the full range of these adjustments.

In addition, business-processing rules must be able to identify wash sale transactions and properly adjust for the disallowed loss.

### **Evaluating the Systems Environment and Addressing Implementation**

Cost basis compliance can affect numerous areas across the enterprise, including account management, asset management, tax reporting, and tasks and processes, such as development, training, testing, software, form design, database cleanup, shareholder communications, programming, and procedures. Each of these areas may have supporting systems that merit a thorough evaluation, uncovering further opportunities for improvement, automation and streamlining.

After requirements and capabilities are identified in the various affected areas, firms will need to decide whether to fill the gaps by building the solution or components on their own, or by partnering with a vendor or consultant. The cost of hardware, including the initial capital expense and ongoing maintenance, should also be taken into account, and the solution chosen must be able to integrate easily into existing tax reporting systems. Project managers will be required to estimate and monitor the consumption of resources for product management, project management, development and quality assurance — both for implementation and on an ongoing basis.

Those that decide to take the do-it-yourself approach will need significant depth of expertise regarding the new regulations. Firms that decide to partner will be able to leverage the partner's subject matter expertise. Partnering can also help reduce overall cost and time to market, enable firms to leverage existing solutions, and reduce long-term requirements for staffing support and training.

### **Choosing the Right Solution Partner**

Those that decide to work with a third party should look for a partner that understands the entire industry, not just cost basis. Understanding the intricacies and dependencies between back office processing systems, cost basis calculations and tax reporting can make implementation easier. External partners with deep bench knowledge and expertise in these areas can benefit an institution greatly by facilitating a smooth integration process.

The ultimate solution should be able to integrate into the entire enterprise, not just act as an add-on at the edge of the network or in one part of the system. Cost basis reporting involves multiple systems, and firms need to be able tie them together and draw data from all of them.

### **Planning the Implementation**

A sound strategy will include both the rollout itself and, as stated previously, integration with existing back-office and tax reporting information applications.

Due to the scale of the project, it often makes sense to work with a partner on implementation. The partner can assist with everything from integrating existing systems to testing and validating new implementations and interfaces. The right partner can also help firms identify the less obvious costs of cost basis compliance, allocate existing resources, and determine where new resources may be needed.

### **Delivering Education and Training**

Training and support are two of the more common costs of cost basis reporting that are often not taken into account during a project assessment. Yet front-office staff, sales teams and support personnel must be trained on systems and customer support updates. In addition, firms should consider whether to build a call center or work with a third-party service in anticipation of the increase in client calls.

Brokers must also address how cost basis-related inquiries will be handled, what fund literature needs to be revised, and what information must be gathered when a client or client agent is placing a redemption by telephone. Standing orders for cost basis handling related to clients need to be established.

Additionally, it is important that senior management understand the changes — and the opportunities — and adjust their short- and long-term strategies as a result.

## MOVING FORWARD IN A NEW WORLD

Both large and small firms in the industry believe that cost basis solution implementations will take significant amounts of time, with training taking even longer<sup>4</sup>. The long-term benefits of moving forward, however, should be well worth the effort, because cost basis compliance activities offer firms several important opportunities. First, firms need to work closely with clients, which can help strengthen relationships and reveal new business opportunities.

Firms can also provide more transparency and information to clients as they modify their IT infrastructure and operations to support the necessary cost basis calculation and reporting activities. Cost basis projects can help create new business efficiencies as well. Re-evaluating and streamlining processes will help firms make better use of resources and free staff to pursue new investment, growth opportunities, and clients. They also may find more time to serve current clients and make further improvements to the business.

Cost basis reporting is more than a compliance requirement; it presents firms with an excellent opportunity to influence and improve the way they do business while providing enhanced customer service.

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## FOOTNOTES

<sup>1</sup> TowerGroup, The Hidden Cost of Cost Basis Reporting, January 2010

<sup>2</sup> Celent, Why C-Level Executives Should Be Concerned about the New Cost Basis Reporting Rules, Sept 2009

<sup>3</sup> Some items, such as return on capital, can only be updated after year-end

<sup>4</sup> Celent, previously cited

[www.sungard.com/costbasisreportingengine](http://www.sungard.com/costbasisreportingengine)

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