

1099-B STATEMENTS AND COST BASIS REPORTING

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What you need to know and what you need to do.

When President George W. Bush signed the Emergency Economic Stabilization Act of 2008 (H.R. 1424) on October 3, 2008, he ushered in a new era of tax reporting requirements. These new tax reporting rules now require brokers, not individuals, to accurately report cost basis data to the IRS.

In general terms, this paper will cover what brokers need to know and do to prepare for this new responsibility.

HISTORY

Since the introduction of Capital Gains taxes in 1913, taxpayers have been charged with the responsibility of computing the amount of gains and losses for all financial transactions. Even though there was no distinction between capital gains tax rates and ordinary tax rates at that time, taxpayers were still responsible for adjusting their gains for corporate actions such as splits, mergers, spin-offs, etc. In 1921, tax reporting became more complex with the introduction of a separate capital gains rate. In the 1930s, the introduction of wash-sales legislation further complicated financial transaction reporting.

According to the IRS, ignorance of the law is no excuse for non-compliance. However, because of the sheer complexity of the problem, the IRS has been prevented from enforcing all the rules pertaining to capital gain taxation. This failure of enforcement has resulted in a "Tax Gap," the difference between what investors should report as their gains and what they actually report. In 2006, the investigative arm of Congress, the General Accountability Office (GAO), estimated that 38% of capital transactions were erroneously reported.

Congress realized that only brokers have the means to correctly compute taxpayers' gains and losses. Since 2005, a renewed effort has been underway to change the rules to shift this computation responsibility from the taxpayer to the broker. A major impetus behind these new reporting rules appears to be a research paper entitled, "Debunking the Basis Myth Under the Income Tax," by professors Jay Soled (Rutgers University) and Joseph Dodge (Florida State University). This paper postulates that incorrect or missing basis data costs the federal government roughly \$250 billion over a 10 year period. In September of 2006, Professor Soled testified before the Committee on Homeland Security and Governmental Affairs. After berating the committee for failing to delegate tax reporting responsibilities to the brokerage houses, he challenged committee members individually to try to calculate the cost basis on their personal security holdings. Whether it was this challenge or other political forces, the Emergency Economic Stabilization Act of 2008 (H.R. 1424) was signed on October 3, 2008 by President George W. Bush.

RULES AND RAMIFICATIONS

The Emergency Economic Stabilization Act of 2008 (H.R. 1424) requires issuers and intermediaries, as part of their information reporting responsibilities, to submit accurate and timely recognized gains and losses along with cost basis information. Transfer agents must also track incoming and outgoing tax lots with the correct associated cost basis whenever changing the custodian of an affected security. These new rules shift the burden of calculation for gains and losses from taxpayers to the brokers.

The schedule for the institution of these changes is as follows:

Equities as of January 1, 2011.

Mutual funds and ETF's as of January 1, 2012.

Bonds and Options as of January 1, 2013.

Failure to meet these new reporting requirements can result in two negative side effects: the imposition of costly IRS penalties and lost business from dissatisfied customers. The Emergency Economic Stabilization Act of 2008 (H.R. 1424) includes some very severe penalties for intermediaries (brokers) who report inaccurate gains and losses. For each statement sent to the IRS with any error, the penalty ranges from \$50 to \$250,000. Similarly, the IRS can also assess additional penalties for inaccurate information returns sent to clients.

These new mandatory reporting rules take effect on January 1, 2011. This means that whatever solutions the brokers will use to comply with these new cost basis reporting rules need to be in place well before the end of 2010. At first glance, it might appear that there is no need to get a solution in place until January of 2012, when the Form 1099-Bs are generated for the 2011 tax year. This would be a mistake. If a security is purchased on January 2nd, 2011, then transferred to another custodian on January 3rd, 2011, an accurate cost basis **MUST** accompany the transfer. This means that a solution must be in place by the first trading day of 2011. Given end-of-year code freezes, in which code changes are put on hold from mid-December until early January so as not to jeopardize system functionality with potential software bugs, and strong internal opposition to implementing new systems at the last minute, brokers' cost basis reporting solutions should be in place well before the end of 2010.

THE ISSUES

In order to comply with these new reporting regulations, brokers will need to address several key issues, including the following: (i) commissions, (ii) wash sales, (iii) constructive sales, (iv) straddles and (v) qualified dividends.

(i) COMMISSIONS

Commissions may present an issue for brokers whose Form 1099-B statement generation is rudimentary. Indeed, even Dividend Reinvestment Programs (DRIPs) can complicate reporting. Fortunately, most reasonably sophisticated brokers and their back offices have already addressed these issues.

(ii) WASH SALES

Wash sales constitute a problem area of cost basis reporting. A wash sale is the liquidation of a loss security followed by the subsequent repurchase of the same (or substantially identical) security. Although a wash sale is a relatively simple transaction, the ramifications of the applicable rule are extraordinarily byzantine. A proficient wash sale reporting system makes adjustments to a purchase and sales report to calculate the correct gains and losses. As these adjustments are made, the tax lots that created the issue must have both their cost basis and their holding periods adjusted.

(iii) CONSTRUCTIVE SALES

A constructive sale (also known as *short-versus-the-box*) occurs when an investor creates an offsetting position via a short sale when an available long lot was available but not retired. Unlike wash sales, constructive sales produce realized gains that are independent of any retirement transaction. In order to produce a compliant Form 1099-B, it is possible that the concept of a pseudo-transaction must be accordingly introduced into the broker's client reporting system.

(iv) STRADDLES

A straddle is an investment strategy involving the purchase or sale of particular option derivatives that allows the holder to profit based on how much the price of the underlying

security moves, regardless of the direction of price movement. For tax purposes, two offsetting positions can be considered a single position. Therefore, when one part of a straddle is liquidated at a loss, the loss cannot be realized in its entirety if the other position is still active and contains unrealized gains. A tax-compliant system must identify “unintended” as well as explicitly defined straddles and make adjustments to both realized losses and the cost basis of surviving positions. From a broker dealers’ perspective, straddles most likely will not need to be addressed until the 2013 section of the Emergency Economic Stabilization Act of 2008 (H.R. 1424) takes effect.

(v) QUALIFIED DIVIDENDS

If President Obama extends the concept of “qualified dividends” (with their preferential rate) into 2011, account of this must be made as well.

APPROACHES FOR COMPLIANCE

Brokers can meet their new reporting requirements by (i) building, (ii) outsourcing or (iii) buying a solution.

(i) BUILD

A broker can build a system to handle the above-mentioned challenges in one of two ways. Typically, a broker already has a system in place to execute any of the various lot-retirement algorithms, such as First-in First-Out (FIFO), High Cost and Last-in First-Out (LIFO). Most brokers have fairly good solutions for lot retirement as it is necessary to present inventory reports to their clients through web portals. Most web sites include disclaimers stating that the asset cost basis information delivered is an ‘estimate’ and that accurate computation of this number is the investor’s responsibility. It is also fairly typical that these systems incorporate applicable commissions into the cost basis they report.

Getting from a tax-lot retirement algorithm to a compliant cost basis report requires two primary enhancements to address constructive sales and wash sales. One way is for the broker to enhance the existing tax lot retirement system (typically called a Portfolio Management

System or PMS). The PMS incorporates the calculations within its core logic. The other way to ensure compliance is to analyze the output from the PMS and make adjustments to the gains and losses that are calculated by the core system. The latter approach tends to be easier to accomplish, as the quality analysis process (making sure code changes do not jeopardize system performance) for major changes to the core engine can be quite time-consuming. Given the near-term deadline of the effects of H.R. 1424, a post-processor solution is the approach we endorse.

(ii) OUTSOURCE

Intermediaries can outsource the solution. For a fee, a vendor will send results to the broker's client reporting system. However, outsourcing raises two issues: security of client data and reconciliation.

Insofar as security issues are concerned, the broker's clients will likely be uneasy about their data being shipped offsite (and potentially offshore). Some clients may have legal restrictions in place that prohibit delegation, and the broker risks losing the account entirely once disclosing that the cost basis reporting is being outsourced.

The second issue involves contradictory reconciliation results. A broker's outsource vendor will compute its own lot retirement algorithm, and those results will have to be reconciled with the broker's internal system. At first glance, this seems easy. After all, LIFO is LIFO – how can a vendor get it wrong? Unfortunately, once you consider the adjustments made to holding periods due to corporate actions and delivery events, it becomes clear that two different systems both attempting to compute LIFO retirement may come up with quite different answers. Since many clients prefer FIFO over LIFO, the issue of reconciliation becomes even more challenging.

(iii) VENDOR SOLUTION

Vendor solutions come in two varieties: complete realized gain/loss computation engines and tax adjustment post-processors.

As an all-in-one solution, a complete realized gain/loss computation engine processes a firm's trades and other data to derive purchase and sales information before 1099-B compliant

reports can be delivered to a client reporting system. This data then must be reconciled with the broker's internal purchase and sales reports produced from its portfolio management system. A complete realized gain/loss computation engine is typically processed at an offshore data center. However, many broker clients insist that their investment data remain on-site. As a result, for a fee, some vendors will allow the broker to install the system onsite.

The alternative is a tax adjustment post-processor solution. This solution looks at output (purchase and sales data) from a broker's existing portfolio accounting platform and makes adjustments to that output for events such as wash sales, constructive sales, and qualified dividends. It delivers Form 1099-B compliant purchase and sale reports to a client's reporting system. A post-processor solution can be run either on-site or through an ASP solution.

Although both approaches address cost basis reporting requirements, only the tax adjustment post-processor solution is streamlined in nature, eliminating the need for internal reconciliation.

CONCLUSIONS

This legislation affects brokers, banks, issuers, transfer agents, mutual funds and other intermediaries who must now calculate accurate gains and losses for all of their clients. These institutions must decide whether to buy, build, or outsource a solution. If buying a solution, they must decide whether to buy a system from an industry vendor or partner with a firm that can outsource the problem for them. Regardless of the manner in which brokers choose to address these new cost basis reporting requirements, new software must be implemented now, as the implementation process is often lengthy and time-consuming, particularly since this new software must also be properly integrated with legacy systems. Quality control analysis is mandatory to ensure that the various intermediaries can safeguard against potential penalties and lawsuits.

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99 Park Avenue Suite 330 New York, NY + 1 212 867 5415