

The five myths of
cost-basis preparedness
Achieving compliance with the
Emergency Economic Stabilization
Act of 2008



Computing the gain or loss on securities sold under the new cost-basis reporting requirements is a significant and challenging undertaking for brokers. It is made especially demanding given the limited amount of time to modify client interaction models, systems, and operating practices prior to the Phase I implementation date of January 1, 2011. To complicate matters further, there are key aspects of the Emergency Economic Stabilization Act of 2008 (the "Act") where the industry is looking for the IRS to provide guidance. While the Internal Revenue Service (IRS) is expected to continue to clarify the Act, it is unrealistic to expect all of the industry's questions to be addressed sufficiently. As the industry begins to prepare and respond to the challenges posed by cost-basis reporting, several industry groups have formed to tackle these issues and try to help firms better understand cost-basis reporting. However, each firm will ultimately have to decide how to comply with the intent of the Act.

Indeed, some brokers have been quick to understand the process and technology ramifications, as well as the significance of the efforts that need to be made, to facilitate compliance on January 1, 2011. These brokers have mobilized cross-functional teams that have already begun, if not completed, a broad impact assessment of the Act's requirements, established implementation plans, and allocated a significant portion of their 2009 and 2010 budgets toward their implementation programs.

A number of firms seem to have underestimated the scope and scale of the changes involved and may be struggling to assess the ramifications of the Act. While this lack of awareness is not willful, firms that are not front-loading their efforts toward understanding the impact of cost-basis reporting may ultimately require herculean efforts to comply. In the process, many tradeoffs may be made, which may significantly impact client experience.

Why is there an awareness gap?

What seems to be the difference in the mindset of these two populations of firms? From what we're seeing, firms that have mobilized cost-basis reporting resources generally do reasonably well compared to their peers in customer satisfaction. How cost-basis is calculated will impact what their clients pay the IRS; firms already preparing to address cost-basis may be doing so because they want to make sure their existing customers experience the consistency in client service that they've come to expect. If a firm is not prepared to provide its customers with accurate cost-basis reports, client experience may be significantly impacted. Leading firms are not only looking to create a positive experience for their existing clients, but also looking to add clients from those firms that execute

cost-basis reporting poorly. Finally, these firms realize that a cost-basis system does not stand alone. It is effectively a record that is written-to by each of the firm's trading and operating systems. Larger firms will have 10 or more systems and many more operating practices that will have to be modified as result of the Act.

If the significance and opportunities presented by cost-basis reporting is so clear to some firms, what is causing other normally thoughtful firms to underestimate the impact and effort of the Act? The answer, most probably, is that management has underestimated the significance and impact of cost-basis reporting; as a result, some firms have neither allocated the resources nor established the processes to gather sufficient information to challenge the initial assumptions. Believing and relying on these assumptions and myths could potentially have serious consequences for compliance with the Act in the short term, and client attrition in the medium to long term, given the long implementation cycle of the work involved.

What are these myths?

While they vary from firm to firm, we have examined some of the most common myths that we've encountered and have tried to sweep away the misconceptions.

Myth 1: The law is only relevant to broker-dealers

- While critical to brokers-dealers, the law (rule IRC § 6045) will impact any firm that issues IRS Form 1099-B (Proceeds From Broker and Barter Exchange Transactions).
- Types of organizations impacted by cost-basis reporting include:
 - Broker-dealers
 - Transfer agents
 - Private banks
 - Issuers/stock plan administrators
 - Custodian banks
 - Trust companies
 - Wealth managers
- Broker-dealers vary in their preparedness, but as a whole are far more aware of the wholesale nature of the changes than their counterparts in other businesses.
- Many large financial institutions are made of multiple organizations that must comply with the Act. It is not uncommon for these institutions to have a few divisions that are preparing well, while other divisions are only at the early stages of awareness.

Myth 2: The firm reports cost-basis today so only a few enhancements are required

- We've talked with a number of firms, some of the largest institutions in the industry, and none of the firms we spoke to are providing cost-basis reporting to their customers in accordance with the pending requirements.
- Currently, brokers who provide their customers with cost-basis reporting do so in a directionally correct manner. They provide this information as a client service to help individuals prepare their tax returns and generally have done a good job in calculating and communicating this information. However, IRS rules for capital gain and loss calculations are complex; in many cases, brokers may have made simplifying assumptions to facilitate calculation and may not have provided calculations when the information was not available. Disclosures on the client brokerage statements and in the year-end tax packages indicated as such.
- Some of the cost-basis reporting complexities that will now have to be handled in accordance with IRS requirements:

Myth 3: The firm can't start implementing the rule until the IRS issues final guidance

- Because of the long cycle time needed to implement technology infrastructure and development changes across the multiple platforms that write to cost-basis records, most firms do not have the luxury of waiting to begin implementation. While no one has the ability to perfectly predict what will happen in the future, it is generally expected that IRS guidance will evolve over time and the initial guidance could be less than comprehensive, prompting additional questions and clarifications being sought by the industry.
- Several firms have completed their impact analysis to determine the scale and complexity of the Act, established program management teams and implementation timelines, and budgeted for the next 18 months of implementation. A few firms have already completed business requirements and have begun programming on their early stage enhancements.
- Many firms deciding between building systems in-house or buying an off-the-shelf solution have conducted feasibility and cost studies and have either made a decision or are in the final stages of making a decision.

Transaction types	Broker-dealer implications
Lot relief method	<ul style="list-style-type: none"> • Introduce lot relief selection methods • Provide FIFO* as the default lot relief method • Respond to customer changes in lot relief method
Grandfathered shares	<ul style="list-style-type: none"> • Introduce mechanisms to distinguish pre- and post-effective shares • Make a decision whether or not to provide cost-basis information for pre-effective shares
Corporate actions	<ul style="list-style-type: none"> • Adjust a customer's basis in a security as a result of corporate action events • Develop process to address incomplete cost-basis information
Wash sales	<ul style="list-style-type: none"> • Take into account loss deferrals and related adjustments for wash sales • Implement reconciliations to address discrepancies in holding period and referral computations
Short sales	<ul style="list-style-type: none"> • Report short sales in the calendar year they are closed rather than the year they are entered or opened
Options	<ul style="list-style-type: none"> • Take into account the impact of corporate actions on the underlying securities
Debt securities	<ul style="list-style-type: none"> • Provide cost-basis related to debt securities • Identify the debt securities and apply amortization and accretion rules to each security type

Myth 4: Buying or building a stand-alone cost-basis system will be sufficient

- A cost-basis system does not stand alone. Cost-basis is effectively a record that is written-to by each of the firm's trading and operating systems. Larger firms will have 10 or more systems and hundreds of operating practices that will need to be modified as result of the Act.
- System and data integrity complexities (i.e., integration and enhancements to downstream systems, consistency and availability of data across systems) and methods of historical data capture and maintenance in the existing architecture have to be addressed.
- Organizational complexities (such as training front-office and operations personnel, onboarding and potential realignment of additional resources) and updating documentation (including policies and procedures) are important components of implementation.

* First in, first out

Myth 5: Utilizing a vendor back-office system provides implementation relief for the firm

- The firm will be responsible for coordinating efforts between the vendor and other strategic partners to facilitate a seamless integration of the cost-basis reporting platform. This may be complicated by inherent competitiveness in the market place between new and existing application vendors, resulting in potential implementation delays.
- Creating and executing a communication strategy for the organization to avoid client experience disruptions during cost-basis reporting changes is an important aspect of implementation that needs to be performed by the organization — it cannot be outsourced to a vendor.
- Performing and completing the necessary system and user acceptance testing due diligence will rest with the firm; additionally defining and developing additional management reports and metrics and integrating new operating procedures and their supervision will have to be managed.

Closing the awareness gap

There are, of course, as many nuanced and subtle differences in the reasons for not taking effective action as there are firms on the street. However, implementing the Act is a significant undertaking that will have to be managed across the entire business. Firms should consider performing a detailed impact assessment, establishing a full implementation plan, and securing internal funding for implementation. Failing to do so could potentially result in both penalties for noncompliance and significant customer attrition.

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