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Confronting the Key Challenges of Cost Basis Reporting

Time is of the Essence

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Agenda

- Discuss the key challenges involved in calculating cost basis
- Discuss the opportunities the new law presents
- Discuss the cost basis implementation timeline
- Panel Q&A

Common Transactions That Impact a Security's Cost Basis

Transaction	Definition	Comments
Wash sale	Sale of a security at a loss followed by repurchase within 30 days	<ul style="list-style-type: none"> •An investor may not claim the tax loss; instead, the loss is added to the cost basis and the security holding period is adjusted •Wash sales create tax sub lots that must be independently accounted for •Brokers must report wash sales only for the same security in the same account
Corporate action	Any action by a corporation, including: <ul style="list-style-type: none"> •Cash and stock dividends •Merger and acquisitions •Spinoffs and buybacks 	<ul style="list-style-type: none"> •The classic example is AT&T spinning off the baby Bells, many of which were then reconsolidated into various companies •Obtaining accurate and up-to-date corporate action information is a challenge •Tax treatment of corporate actions and the resulting impact on cost basis are often unclear
Non-purchased securities	Securities acquired by means other than purchase, such as by gift or inheritance	<ul style="list-style-type: none"> •The cost basis of inherited securities is generally the value at date of death, but an alternative valuation date may be used •The cost basis of securities acquired by gift depends on the donor's basis and the fair market value at the time of the gift

Steps in Calculating Adjusted Cost Basis

Original Basis Depends On How Acquired

- Cost basis of purchased shares is the price paid plus costs
- Cost basis for shares acquired by gift is the cost basis of grantor/donor
- The cost basis of inherited shares equals the value at date of death or an alternative valuation date

Adjust For Corporate Actions

- Mergers, acquisitions, spinoffs, stock rights, dividends can all impact basis
- Voluntary corporate actions need to be handled at the account level
- Complete data on corporate actions is essential (tax treatment of foreign securities is a challenge)

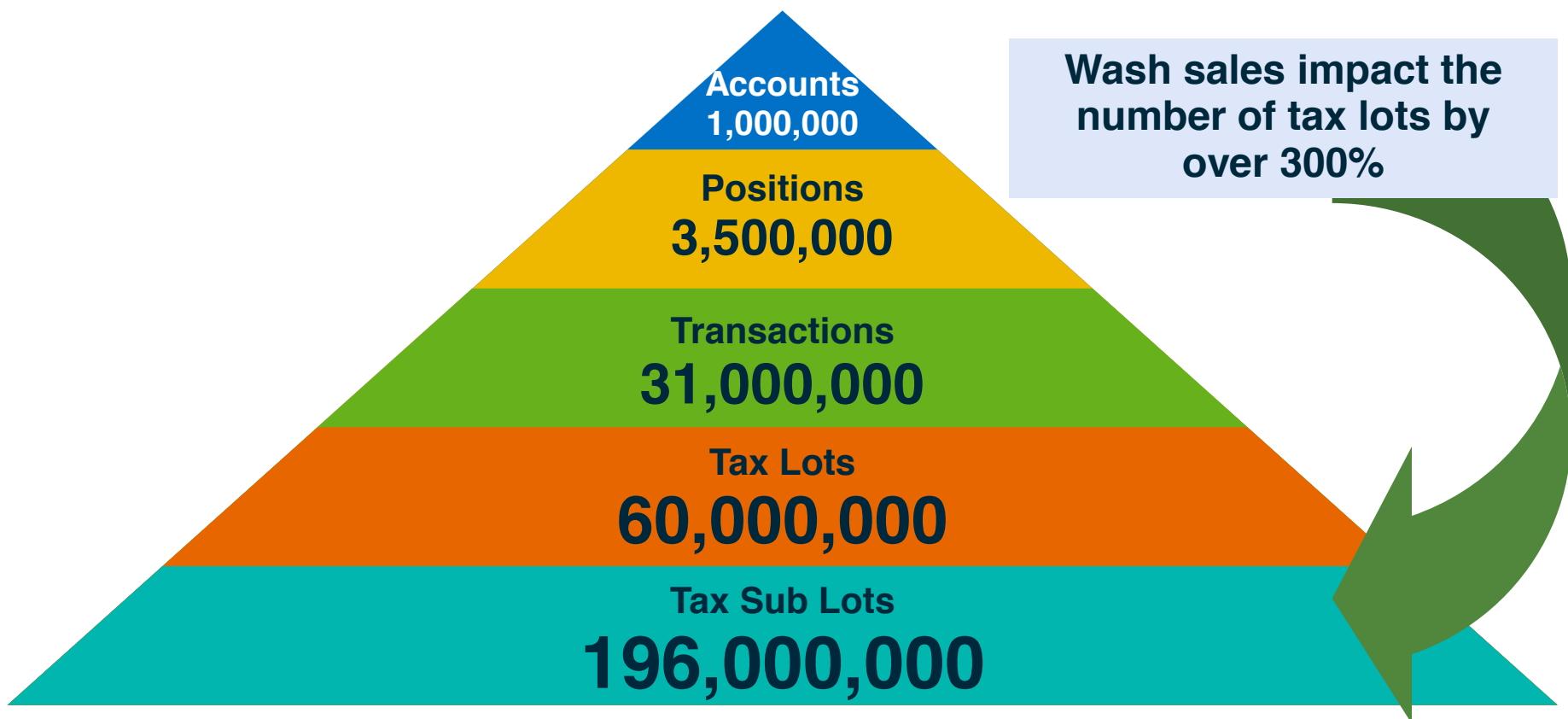
Adjust For Wash Sales Or Short Sales

- Adjusting for wash sales requires creating tax sub lots to be tracked on an ongoing basis
- Most brokerage platforms are currently not designed to handle sub lots
- Short sales are complex and challenging to account for accurately

Determine Gain/Loss & Short/Long

- Amount and character of gain/loss must be tracked
- Shares purchased prior to required implementation dates (2011–13, depending on security type) must be segregated
- Gain/loss must be reported to the Internal Revenue Service and customers on Form 1099-B

The Impact of Wash Sales on Back-Office Systems



Methods of Calculating Mutual Funds Cost Basis

First In, First Out (FIFO)

- IRS uses FIFO if no other method is chosen by the customer
- First shares purchased are assumed to be first shares sold

Average Cost (Single Category)

- Method most commonly used by fund companies
- Method averages the cost of all share purchases and divides by the number of shares

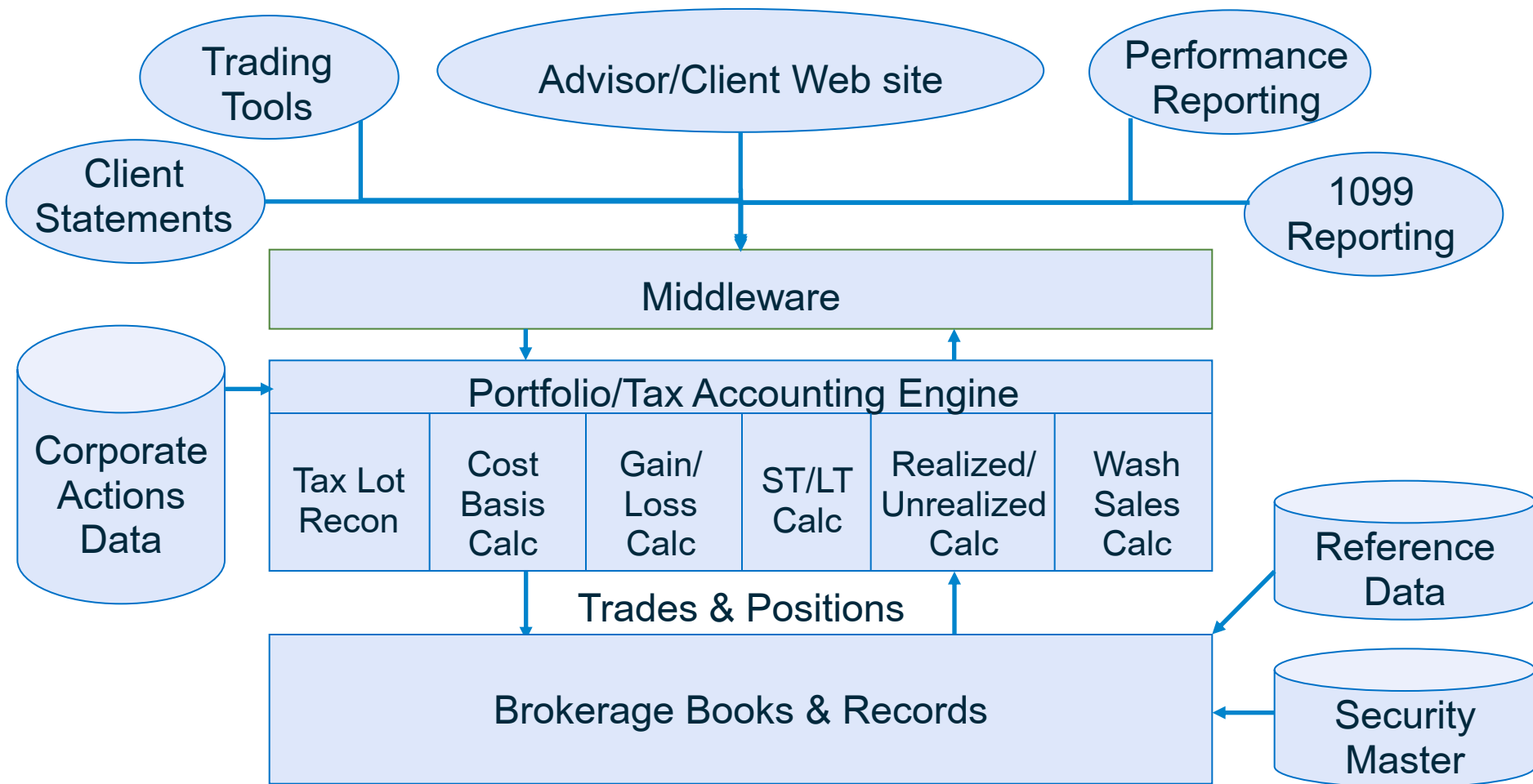
Average Cost (Double Category)

- Similar to single-category method, but divides shares into short- and long-term buckets
- When selling, the investor can choose whether to sell the short- or long-term bucket

Share Identification

- Generally the most advantageous method
- Customer must specify shares to be sold by date or price
- Customer must receive written confirmation that shares were actually sold

Hypothetical Integration of Cost Basis into Wealth Management Platform



The Potential Enhancement of Existing Systems with Real-Time Cost Basis Information

Statements can be enhanced to show embedded gains/losses

Statement Generation

Trading Interfaces can be upgraded to allow customer to identify specific shares to sell

Trading Interface

Cost basis information can be fed to advisor desktops to enable tax loss harvesting

Advisor Desktop

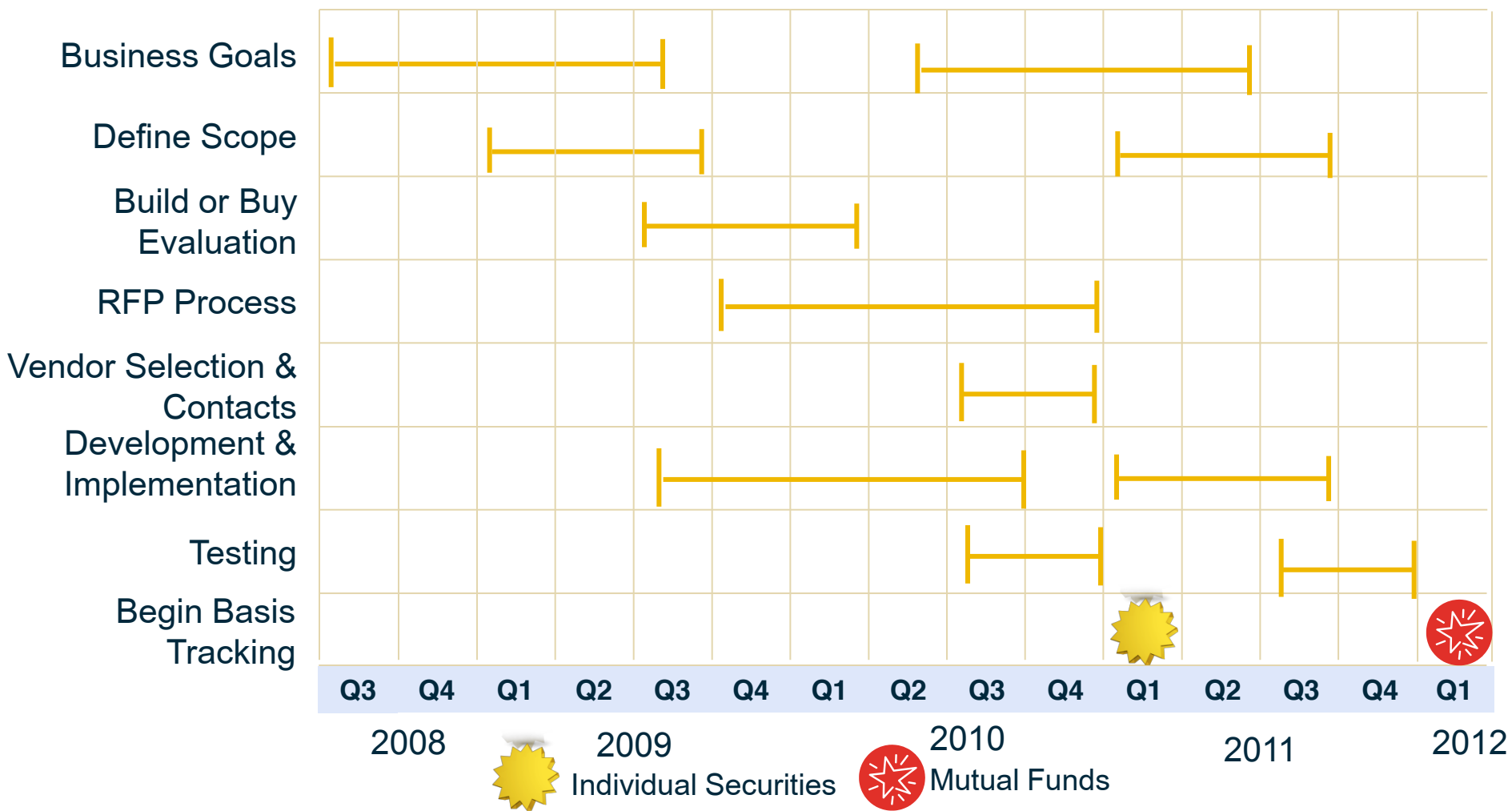
Rebalancing can be optimized to reduce tax liability

Rebalancing Engine

Planning application can be designed to tax optimize the drawdown of assets

Planning Applications

Sample Cost Basis Timeline



Key Take-Aways

- Handling complex transactions such as wash sales and processing corporate actions automatically are some of the more pressing challenges financial services institutions must tackle.
- Many current cost basis systems do not track every cost basis method or allow customers to choose a method; retail brokers must act immediately to update these systems if they are to meet implementation deadlines.
- The need to integrate cost basis solutions with existing systems such as trading interfaces and IRS Form 1099 tax reporting systems adds to the technology challenges.
- TowerGroup expects two types of firms to emerge: those that simply comply with the legislation and those that look to gain a competitive advantage by using cost basis data to build tax management functionality
- Time is of the essence, retail brokers must not delay cost basis projects, the first deadline in 2011 will be a challenge for many firm due to the complexity of the changes and resource constraints

Questions

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