Tax management: Navigating a perfect storm of tax complexity

An executive briefing on how financial services firms can reduce the risks and costs of tax management
EXECUTIVE SUMMARY

A perfect storm of increased tax complexity is descending on broker-dealers of all sizes across the globe. The convergence of accelerated government regulations, increased tax reporting requirements, and growing client demands significantly increases firms' risks and costs.

Factors contributing to this perfect storm are:

- New IRS cost basis reporting requirements in the U.S., which are phasing in over three tax years (2011-2013)
- Provisions of the Foreign Account Tax Compliance Act (FATCA) for identifying U.S. taxpayers' foreign accounts and assets
- Enhanced tax reporting detail and backup withholding requirements by governments at different levels and across many jurisdictions (federal, provincial, state, local)
- Increased demand for tax reporting accuracy, transparency and timeliness throughout the year — not just at year-end

This perfect storm is increasing pressures on broker-dealers' tax departments. Small cracks in tax systems are growing larger under the stress of processing more data and resulting in more errors and costly corrections. Time is of the essence to make changes in order to attain tax reporting economies of scale, achieve regulatory compliance, and deepen tax expertise.
The Growing Costs of Complexity

Broker-dealers of all sizes are being flooded by accelerated tax complexities while tax reporting costs are rising at a rate that makes executive management take notice. The 2011 tax reporting season was difficult for many firms, especially those with less-than-robust reporting systems or small tax staffs. Many firms were forced to hire temporary workers and permanent tax staff worked around the clock. As a result, correction rates were well above average and many firms required extensions — delaying returns and increasing costs.

Broker-dealers reported 2011 “tax processing stress” due to:

1. The ongoing challenge of implementing new tax-reporting technologies
2. Increased tax reporting processing costs and budget pressures
3. “Staffing limitations” during the critical January-April tax reporting season

Four factors have converged to create a perfect storm of new tax reporting complexity and overhead:

1. Cost basis reporting drives the need for tax system reengineering
   Starting in tax year 2011, investors taking gains or losses on common stocks or Exchange Traded Funds (held in taxable accounts) were sent 1099-B forms that included two new lines (7 and 8) reporting: 1) the investor’s gross adjusted cost basis in “covered” securities sold; and 2) whether these gross gains or losses are short-term or long-term. The IRS will automatically try to match these gross numbers with taxpayer returns. Broker-dealers must be prepared to minimize misalignment potentially leading to further review of security transaction details under IRS inquiry or audit.
   Over the next two years, the same 1099-B requirements will phase in for other types of securities including: mutual funds and dividend reinvestment plans for tax year 2012, taxes and fixed income securities, options, commodities and derivatives for 2013. Delivering technology and operations solutions for these requirements are very complex and costly.

EXHIBIT 1
Cost Basis Reporting Solution Costs: In-House vs. Third-Party

Cost Basis Reporting: Cost By Deployment Method (2009E)

IN-HOUSE
For cost basis reporting solutions developed in-house, please provide the total estimated cost of development and implementation

THIRD-PARTY
For cost basis reporting solutions acquired or built by a third party, please provide the total estimated cost of implementation

Source: TowerGroup 2009 Cost Basis Reporting Survey
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According to Peter Delano, Senior Research Director, CEB at TowerGroup Wealth Management, “The disparity between expected spending on in-house versus third-party cost basis reporting solutions is striking. TowerGroup’s 2009 Cost Basis Reporting Survey revealed that all financial institutions working on in-house development of cost basis solutions expected to spend at least $3 million, while 68% of respondents looking at third-party solutions expected costs of less than $1 million.”

2. The Foreign Account Tax Compliance Act (FATCA)

Beginning with 2011 tax filings, the IRS required a new Form 8938 to be filed with income tax returns to report “specified foreign financial assets” in excess of a threshold. This change is mandated under the Foreign Account Tax Compliance Act (FATCA), which Congress passed in 2010 to curtail tax evasion by U.S. persons using offshore accounts.

By June 30, 2013, Foreign Financial Institutions (FFIs) must directly report to the IRS their account holders who are U.S. persons or foreign entities with substantial U.S. ownership. In certain cases, they must also withhold 30% of payments or sale proceeds of U.S. source income. This change will require FFIs to “drill down” into the ownership structure of certain entities, such as partnerships and hedge funds, to determine the ultimate owners and their U.S. tax obligations. It will impose new burdens on broker-dealers’ account-opening process, including changes to Know Your Customer (KYC) due diligence and documentation process.

The bottom line: Governments around the globe (federal, provincial, state, local) are looking for ways to increase tax revenues. As a result, brokerage firms bear a growing burden for reporting and withholding proper state taxes.

3. Complexity of expanding tax requirements across jurisdictions call for in depth Tax Expertise

The state of California, which often sets tax trends for other states, began requiring 7% backup withholding in 2010 for residents subject to federal withholding. Several other states are implementing rules designed to capture tax revenues legitimately owed to the state (but often under-reported) on securities transactions. For example, Connecticut, New York, Minnesota, and Montana have begun requiring broker-dealers to match all data on Form 1099-INT (annual interest) to individual municipal bond CUSIPs, to verify that taxpayers are entitled to exempt the interest on their state returns.

4. Increased demand for real-time tax reporting and information

The success of online financial services firms has changed the landscape for tax reporting and raised the bar for real-time transparency. Instead of focusing on year-end reporting, leading broker-dealers now support year-round tax services such as daily and monthly cost basis reporting statements, online access to reports, and tax planning analytical tools.

Detailed and accessible tax reports increase confidence in the tax planning services that wealth management advisors offer to their clients. This cultivates accountants as centers-of-influence resulting in increased client referrals and recommendations.

Advantages of Tax Management Services

Tax Management Services is often defined as a solution that supports any back-office platform and cost basis technology, while offering personnel year-round for reporting of tax transactions. This solution can be a viable and cost-effective method for managing tax complexities including staff
dependency, infrastructure capacity constraints, and the risks of operating an in-house tax processing unit. In addition to pooling resources, a Tax Management Services provider enables firms to capitalize on industry best practices and operational expertise in an area where most don’t currently attempt to compete or differentiate. This gives firms more flexibility to divert expenditures to develop their own front-end tax services, or other products and services that do differentiate their clients’ experience and give advisors a competitive edge.

**Achieve economies of scale**

Year-end tax reporting validations and quality assurance are examples of operational economies of scale, which can be achieved through a tax service provider. As regulations continuously and rapidly evolve, outsourcing eliminates the need to “reinvent the wheel” each year and having to format similar “necessary changes.” A service provider effectively pools many firms’ resources to create shared solutions and attractive economies of scale. Plus, with the potential repeal of the Bush tax cuts, a tax management partner can significantly reduce the cost of unwinding changes that have already been made.

**Manage multi-language requirements**

The first wave of IRS-mandated cost-basis reporting in 2011 has left broker-dealers reeling. Industry sources anticipate complexities and pressures will magnify due to increased fixed income reporting in 2013. Vexing challenges are anticipated in such areas as original issue discount (OID) accretions, bond amortizations and accruals, and phantom income. Outside the U.S., complexities expand in different directions, including meeting government requirements to translate tax reports, disclosures and instructions into multiple languages. In Canada, for example, tax reports must satisfy three languages: 1) English and French for the Canadian Revenue Agency; 2) French for Revenue Quebec, and 3) English for the IRS. A tax partner provides a team of experts for managing such complexities while taking advantage of industry best practices.

**Spread the work load**

While tax reporting is considered a standard industry function in a complex area, staff salaries are high. Engaging a provider leverages the skills and knowledge of high-cost workers across multiple firms and helps reduce staffing budgets while minimizing errors caused by “temps” who are not familiar with a firm’s processes and systems.

In addition, a tax partner prevents staffing gaps at financial services firms lacking “deep bench strength” where the loss of one key tax expert during peak season can result in costly mistakes and significant client service issues.

**Leverage technology for year-round tax transparency**

Online brokerage accounts and rising customer expectations have changed tax reporting from a year-end event into a year-round process. Through a provider, firms can utilize proven technologies and processes designed to streamline reporting and keep cost basis data in real-time. By making the staffing commitments required to maintain tax data around the clock and around the calendar, outsourcing firms enable online tax report access, with full transparency for advisors and investors.

**Reduce corrections and increase cost-efficiency**

A basic metric of tax reporting efficiency is the percentage of corrections that must be made in response to government and corporate tax notices, operational issues or customer complaints. Since corrections are a costly component of tax reporting, reducing correction rates is a key to Tax Management Services’ cost-efficiency. Industry sources indicate that correction rates of 10% have been typical in the past, and this percentage may increase as the complexities of cost-basis reporting phase in through 2013.
“To maintain accurate cost basis data, you need to work at it every day with a continuous commitment — to understanding regulations, monitoring corporate events and developing expertise.”

Michael Alexander, President at Broadridge Business Process Outsourcing Solutions

According to Michael Alexander, President at Broadridge Business Process Outsourcing Solutions: “To maintain accurate cost basis data, you need to work at it every day with a continuous commitment — to understanding regulations, monitoring corporate events and developing expertise. Tax reporting with cost basis is truly a report card of a broker-dealers’ day-to-day operational performance.”

Leading tax service providers consistently deliver correction rates below 1%. They also can help financial services organizations monitor correction metrics and identify problem areas generating excessive correction rates. Lower correction rates, in turn, lead to increased client and financial advisor satisfaction.

Reduce Tax Complexities in Three Steps: Technology, Operations, and Client Experience

Firms must consider the increased costs and risks of tax reporting, their own capabilities, and clients’ expectations.

Tax complexity increases when local, state and international regulations come into play. As these complexities continue to rise, broker-dealers should assess their current capabilities across three key areas: technology, operations, and client experience.

How to Reduce Tax Complexities

Step 1: Build a Robust Technology Framework

Technology provides the framework for broker-dealers to meet the demands of rapidly-increasing tax complexities. Firms should consider their current technology platforms to determine if they have the appropriate functionality and an end-to-end solution to meet today’s growing tax processing and reporting requirements.

Self-assessment: Technology

Key questions firms should ask themselves to evaluate their technology capabilities:

- Do we have a front-to-back office technology strategy that keeps costs and risks manageable?
- Are we able to accurately measure our tax operations costs?
- Are we ready to support FATCA, including Foreign Financial Intermediaries and non-resident alien (NRA) reporting?
- Does our solution offer cost basis reporting support including online access to real-time data for advisors and investors with sufficient archiving?
- Do we have business rule flexibility to adapt to regulatory changes across countries and states without relying on manual processes or significant investments in technology?
- What will it cost to update systems and continuously keep-up with rapidly evolving regulatory change?

Step 2: Evaluate Your Tax Operational Performance

Assessing current operational capabilities is critical for firms to help identify processing gaps. Understanding tax requirements in multiple jurisdictions and knowing how to implement solutions for new regulations can help reinforce a firm’s operational capabilities.

Self-assessment: Operations

Key questions firms should ask themselves to evaluate their operational capabilities:

- Do we have tax expertise in multiple jurisdictions, including the U.S., Canada, and European financial centers to mitigate risk?
• Is our team ready to adapt to new tax legislation and regulations?
• How deep is our current tax staff and can we handle the loss of a key employee?
• How much staffing and technology flexibility do we have to handle high volume peaks such as year end?
• Can we provide operational support in multiple local time zones?
• How do our operations measure against industry benchmarks?
• Do we have the ability to invest in tax operations efficiencies?

**Step 3: Create an Unparalleled Client Experience**
Perhaps most importantly, firms need to ensure a satisfying client experience by delivering timely, accurate, and scalable solutions to meet the growing clients’ demands. The bottom line objective is to develop a service model that optimizes the global client experience.

**Self-assessment: Client Experience**
Key questions firms should ask themselves to evaluate their client experience:

• Can we support increasing client and internal stakeholder demand for enhanced information and service?
• Can we offer a differentiated client experience depending on wealth segment?
• How does our solution compare with key competitors in terms of comprehensiveness and ease of use?

**Conclusion**

Leveraging a partner to deliver cost-effective tax solutions can improve your firm’s ability to handle the increasing complexity of tax reporting while enabling cost reduction, an end-to-end solution, and the incorporation of industry best practices.

In 2012, broker-dealers are in the eye of a perfect storm of tax reporting complexity. Its intensity will only increase in the years ahead as cost basis reporting requirements phase in, FATCA compliance pressures increase, governments search for revenues, and clients demand more real-time access and transparency.

By beginning your evaluation of Tax Management Services partners now, you will put your firm in the best position to address even more complex tax issues that may be coming in the future.

Many financial services firms are finding that outsourcing their tax programs allows cost-effective growth opportunities while reducing in-house risks. These programs also simplify compliance, reduce tax reporting corrections and customer complaints, assure industry-best service levels, and control or reduce costs.

To deliver the industry’s best practices in Tax Management Services, you don’t need to allocate more resources to legacy systems or increased staff expertise. There is a viable, economical alternative.

**This is where Broadridge can help.**
Contact Us
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