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Investment Management and Cost Basis Accounting -- A New Paradigm

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Investment Management and Cost Basis Accounting -- A New Paradigm

In the past, the Internal Revenue Service allowed the investor to track and report cost basis on investments. Custodians were required to report certain information relating to the sale of investments, such as the date of the sale and the amount of the sale proceeds on Form 1099-B. The investor was required to provide the acquisition date and purchase price on Schedule D. This gave the investor ultimate control over determining gains or losses on investments sold. In 2011 the world changed as it relates to reporting and accounting for investment cost basis. Effective that tax year, new regulations were rolled out for equities and ETFs that stemmed from the Emergency Economic Stabilization Act enacted in October 2008. All investments will be covered under the new regulations by tax year 2016.

Security Type	Acquisition Date (on or after)	Effective Tax Year
Equities and ETFs	January 1, 2011	2011
Mutual Funds & Dividend Reinvestment Plan Shares	January 1, 2012	2012
Less Complex Debt and Options (including warrants and rights)	January 1, 2014	2014
Complex Debt and Options	January 1, 2016	2016

The rule requiring taxpayers to report capital gains and losses to the IRS has not changed. However, now that custodians are required to report cost basis to the IRS on form 1099-B,[1] investors may no longer determine their realized gains or losses after trading, but rather must ensure that their intended actions are carefully planned and coordinated before any trading takes place.

Different Needs, Different Books of Records

Recently, the concept of an Investment Book of Records (IBOR) has gained popularity. IBOR refers to investment data used to supply accurate information to the front office in support of an investment management process. This includes what a manager may trade, such as intraday share positions and pending transactions. IBOR is distinguished from data used in support of back-office operations, commonly known as Accounting Book of Records (ABOR). ABOR supports back-office business functions and includes data for such needs as daily NAVs, regulatory reporting, fund administration, and transfer agency services. Those managing individual investor portfolios must reconcile to a custodian's records, but do not need the fund administration information found in ABOR. Based on the IRS regulations, it may now be appropriate to consider a third type of record, the Custodian Book of Records (CBOR).

We have coined the term Custodian Book of Records to describe the tax reporting data being provided to the IRS by the custodian. This has always included income but now includes realized gains and losses as well. From the IRS' perspective, putting the onus on the custodian to report BOTH income and realized gains and losses makes sense since they are inter-related in many cases. For example, certain bonds purchased at a premium or discount may have their cost basis adjusted by amortizing a premium or accreting a discount, but the cost basis adjustment amount may not be reported as a realized gain/loss when sold. Instead, the adjusted cost may be reported as ordinary income similar to coupon interest or dividends. In other cases (e.g. muni bonds purchased at a premium), the theoretical loss taken at

[1] *US Internal Revenue Service, "Cost Basis Reporting FAQs," http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Cost-Basis-Reporting-FAQs*

maturity cannot be recognized as a realized loss because the excess interest income was already tax advantaged when received by the investor.

While it is important to reconcile IBOR to CBOR, the two will not always be in synch with each other. One of the most common differences between IBOR and CBOR is trade-date based accounting (IBOR) versus settlement-date based accounting (CBOR). Temporary differences between the two books of records are common in that the IBOR anticipates what the CBOR will reflect when activity has settled. Reconciling IBOR to CBOR can quickly strain an investment manager's back-office resources when complexities such as multiple tax lots for a single position and multi-sleeve accounts managed by different firms are present.

However, with the change in law, the only data that is of consequence to an investor is what will be reported to the IRS. And there may be very little benefit in attempting to perfectly match IBOR to CBOR as there are many reasons that the two books of records could – or should – diverge. A carefully selected technology and accounting solution that allows an investment manager to accurately implement its strategies across accounts may not, and likely should not, work in the same manner as a custodian's technology solution. The two are solving different needs. Take, for example, the following list of likely differences between IBOR and CBOR:

- Source data
  - Custodian's records may have differed from those contained in the IBOR at the time the reporting requirement began
- Cost basis methods
  - In the absence of an investor's direction for cost basis methods to be used, the default method for stocks acquired after 2010 is first-in first-out (FIFO). For mutual funds shares acquired after 2012, the default method may be chosen as FIFO, or an average cost.
  - Should the IBOR rely on a different method, divergence will happen with the first sale and would impact all future transactions.
- Corporate actions
  - Cash vs. stock options
  - Spin-offs and certain mergers
  - Return of capital
  - Rights offerings and conversions
- Delivering and receiving of securities
  - Receiving securities with unknown original cost
  - ACAT of securities where the "to" side allows cost basis to be updated
- Multi-currency transactions
  - Exchange rates at transaction level establish base cost
  - Cost of currency can cause a realized gain on any transaction, not just sells
- Versus purchase trade activity
  - Will a custodian accept versus purchase trades
  - How will cost be recorded for sell orders where the requested lots do not match broker records

> "Because gain/loss information will be included on Form 1099-B, your firm may consider ending the practice of generating in-house gain/loss reports for clients and free up time for other tasks." [2]

> Even if you match your IBOR with CBOR, you must realize that the custodian can -- and will -- adjust the cost basis on historical transactions after-the-fact based on new information that may not have been available at the time the original sell transaction was entered.

[2] Charles Schwab, "Cost Basis Reporting: Preparing for 2012," pg. 10; http://content.schwab.com/web/as/public/costbasis/pdf/2012_Cost_Basis_White_Paper.pdf

    - "Trading away" transactions
- Additional considerations
    - Convertible bond conversions
    - *Ex post facto* cost basis adjustments by the custodian

Investment managers considering the inclusion of cost basis information in their IBOR should answer two questions: What is the source of the cost basis, and how will the cost basis information be used? In doing so, there is an opportunity to overcome the inertia of habit and address actual needs with the new rules in mind.

> "One of the biggest challenges for RIAs is ensuring their portfolio management software is synchronized with the information and system used by their custodian. RIAs using multiple custodians need to ensure that the cost-basis information they have documented is passed on to clients by the custodian in with the same numbers.
>
> In a typical workflow, the investment manager is never talking to the custodian. Orders go to the broker, then to the DTC (Depository Trust Company), then come back to the investment manager and, through the DTC, to the custodian. To successfully execute and settle lot-specific sells, every one of the involved parties must carry versus-purchase information." [3]

If the answer to the first question is anything other than, "custodian provided data," a manager should not use it. Remember, the only data that is of consequence to an investor is what will be reported to the IRS. Given investment managers' relationships with multiple custodians, committing to use custodian data in the IBOR requires a careful analysis of the custodian data format, update frequency, and change maintenance requirements. With multiple custodians, these issues would need to be addressed in turn for each.

The answer to the second question, how will the cost basis information be used, is likely reporting, trading, or both. Given the impact of the new law, the use of anything other than custodian-provided cost basis information for reporting can be a very risky proposition. The impact of this was described very succinctly in a document from Charles Schwab: "The days of cost basis reporting as a value-added service are over."[3]

In the past, it was common for investors to receive a "tax summary" report from their investment managers that included realized gains and losses. However, with the IRS receiving cost-basis information directly from the custodian, at best a manager can provide only what will already be provided by the custodian. The good-will benefit to an investment manager from providing a tax summary report based on anything other than custodian data is erased by the significant downside risk of providing incorrect information.

As far as the use of cost basis information for trading, there are a few additional considerations. Will trading be "tax aware," which is to say that overall gains and losses will be considered? Are sells being performed to satisfy a client request to "harvest" gains or losses? Is trading being determined by a tax-optimized process, often by employing third-party software?

For a "tax aware" approach to trading, it is typical to look at overall gains/losses at the position level rather than at specific lots. Obtaining and maintaining accurate total cost can be much less resource intensive.

For gain/loss harvesting and tax-optimized trading, it is imperative to use data from the custodian. Typically, gain/loss harvesting is performed infrequently, and in consultation with an investor.

[3] Fidelity Institutional Wealth Services, "Cost Basis Regulations and Your Firm," https://fiiscontent.fidelity.com/947859.pdf

For tax-optimized trading, the frequent need for tax-lot data means that custodians must be able to provide frequent, scheduled data loads, and that data must often be formatted in order to be ingested by third-party software. For both tax aware and tax-optimized trading, sell transaction data must include versus-purchase information to ensure the intended tax lots are sold. If a sell transaction specifies a tax lot that does not match the custodian, there is a risk that it could be settled using a different lot. Consider the following from Fidelity Institutional Wealth Services, “One of the biggest challenges for RIAs is ensuring their portfolio management software is synchronized with the information and system used by their custodian.” [4]

Summary

Investment Managers’ portfolio accounting needs are complex and not without significant risk. Accepting that the world of tax lot accounting has changed, the most accurate data to use for reporting and tax trading would be source data from the custodian. However, integrating the systems and process requirements of ABOR, IBOR and now CBOR can require significant resources that may otherwise be used toward the firm’s core competence and the Investment Manager’s avocation: portfolio management and client relationship building.

[4] Charles Schwab, “Cost Basis Reporting: Preparing for 2012,” pg. 2; http://content.schwab.com/web/as/public/costbasis/pdf/2012_Cost_Basis_White_Paper.pdf