



COST BASIS REPORTING: PREPARING FOR 2012

Next Phase Covers Mutual Funds, ETFs and DRIPs

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EXECUTIVE SUMMARY

On January 1, 2011, the first phase of new tax reporting requirements took effect, dramatically changing the way independent registered investment advisors (RIAs) and their clients think about cost basis. For the first time, brokers are required to report the adjusted cost basis of sold equity securities to the IRS. The new requirements are designed to help capture accurate reporting of investors' gains and losses at tax time.

In the months leading up to the first phase of the legislation, many brokers and advisors moved swiftly to prepare their firms and clients for the coming changes. But there is more work to be done as the second phase nears—and the potential for client confusion will likely be higher.

Advisors should plan now to prepare their clients for the next wave of changes, which affects mutual funds, dividend reinvestment plans (DRIPs) and some exchange-traded funds (ETFs) beginning January 1, 2012. At the same time, clients need to understand the revised Form 1099-B that will arrive in early 2012, containing cost basis information reported to the IRS on covered equities sold in 2011. Advisors who proactively reach out to their clients can be in a better position to help them through this transition.

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KEY CHANGES TO COST BASIS REPORTING

The days of cost basis reporting as a value-added service are over. Custodians and brokers are now required to report cost basis on equities, and mandatory reporting on mutual funds, ETFs and DRIPs will start in 2012.

Overview of Regulations

The Emergency Economic Stabilization Act of 2008 included new tax reporting requirements, mandating that custodians, broker-dealers, transfer agents and other reporting entities (collectively referred to as “brokers” for purposes of this paper) report the adjusted cost basis of sold securities, including whether the gain or loss is short- or long-term, to the IRS and your clients on Form 1099-B.

The requirements are phasing in over three years, starting in 2011:

- The first phase took effect on January 1, 2011, covering equities acquired on or after that date. These changes will be most noticeable to clients in early 2012, when they receive the new Form 1099-B reporting cost basis information. Cost basis information on any equities bought and sold in 2011 will also be reported to the IRS.
- The second phase begins on January 1, 2012, covering mutual funds, DRIPs and most ETFs acquired on or after that date. Brokers will be required to report this information to the IRS for the first time in 2013 on Form 1099-B, covering the 2012 tax year.
- The third and final phase takes effect on January 1, 2013, covering other specified securities, including fixed income and options. The IRS had not yet issued regulations on this phase as of the date of this writing.

These changes have two important implications for the way advisors approach cost basis reporting. First, advisory firms that track and report cost basis data to clients need to ensure that their reports match the data sent by brokers. Second, for tax-sensitive investing, firms need to consider the tax consequences of a trade at the time of trade, because cost basis methods cannot be changed after the trade settles.

COVERED VERSUS UNCOVERED SECURITIES

The legislation is rolling out in three phases, as listed in the chart below. Covered securities are those acquired on or after the applicable dates outlined by the legislation. Securities acquired by clients before these dates are uncovered by the legislation. Brokers are not required to report cost basis on uncovered securities. Taxpayers are responsible for accurate reporting of cost basis on covered and uncovered securities to the IRS on their tax returns.

| | Covered securities | Uncovered securities |
|---|---|---|
| Equities* | Acquired on or after Jan. 1, 2011 | Acquired prior to Jan. 1, 2011 |
| Mutual funds, dividend reinvestment plans (DRIPs) and most ETFs** | Acquired on or after Jan. 1, 2012 | Acquired prior to Jan. 1, 2012 |
| Other specified securities, including fixed income and options*** | Acquired on or after Jan. 1, 2013 | Acquired prior to Jan. 1, 2013 |
| Taxpayer responsibility | Brokers will report cost basis to IRS and taxpayers on Form 1099-B. Taxpayers will use Form 1099-B data in preparing their tax return filings for 2011 and following years. | Brokers may report cost basis on Form 1099-B or a supplemental report. Taxpayers will report cost basis to IRS. There may be differences, and taxpayers should report what they know. |

* Equities include corporate stock (other than stock in a regulated investment company [RIC] or stock acquired in connection with a dividend reinvestment plan [DRIP]). Internal Revenue Code section 6045(g)(3)(C)(i) provides that the applicable date is January 1, 2011.

** Not all issuers of ETFs elect that they be treated as RICs. For stock in a RIC [RIC stock] or stock acquired in connections with a DRP or DRIP (DRIP stock), section 6045(g)(3)(C)(ii) provides that the applicable date is January 1, 2012. Regulations define a DRP or DRIP, to include any written plan, arrangement or program, administered by an issuer or non-issuer of stock, under which at least 10 percent of every dividend (within the meaning of section 316) on any share of stock is reinvested in stock identical to the stock on which the dividend is paid. If this requirement is not met, then the plan will not qualify as a DRP for purposes of cost basis reporting and stock acquired in the plan will be subject to the 2011 effective date. DRPs are eligible for the average basis method.

*** For any other specified securities, section 6045(g)(3)(C)(iii) provides that the applicable date is January 1, 2013, or a later date to be determined in the future. The reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2013, as provided in section 6045(h)(3).

Recap of 2011 Changes

Here's a look at what's changed since the first phase of the legislation took effect this year:

Cost basis default method. The legislation requires brokers to use a default cost basis method for calculating gains and losses unless a client or advisor acting on behalf of the client chooses another. For equities, the IRS default on sold securities is the First In First Out (FIFO) method.

“The first phase of the legislation was probably the smallest step, and now, with mutual funds to be covered in Phase II, reporting is going to get more complex. This increasing complexity likely supported Congress's rationale for staggering the effective dates of the legislation.”

— Deanna Flores, KPMG

Advisors and their clients can change the default method or override it for a specific trade. There are various other methods to specify lots, including high cost, low cost, Last In First Out (LIFO) and specific share identification. Some brokers may offer an option that uses an algorithm to maximize tax

benefits. These cost basis methods must be specified either at the time of a trade or through a standing order. Each broker may offer different cost basis method choices—check with yours to find out which are available to you.

Specified lot decisions before the trade settles.

For all securities, specifying a lot or changing cost basis method must be done at the time of trade or before settlement date, typically within three days for equities and one day for mutual funds. Once the trade settles, the method used will be final and cannot be changed.

Transfer of cost basis information.

The legislation specifies that brokers must provide a transfer statement when transferring assets to another broker. Transfer statements for covered securities must include the transfer date, security identifier, acquisition date, covered or uncovered status, cost basis and holding period. For RIAs, receipt of the transfer statement will be a timesaver because the receiving broker no longer needs to follow up to obtain cost basis on these positions. However, if a security is transferred between institutions without the transfer statement, that security will be considered uncovered at the time of receipt. Securities can become covered once the appropriate cost basis information is provided.

Gifted and inherited shares transferred

between accounts. When gifted and inherited shares are transferred between accounts, they must be identified, and applicable accounting rules must be applied to the gain/loss. For gifted shares, this includes capturing the date of the gift and the donor's adjusted cost basis and the fair market value (FMV) of the shares on the date of the gift. If the donor's adjusted basis exceeds the FMV when the gift is made, special rules apply that limit the loss the gift recipient can claim when the shares are sold. For inherited shares, the broker is generally required to value the security on the date of the account holder's death unless the estate executor instructs the broker to use an alternate date.

Tracking and reporting on wash sales. The new law requires brokers to report loss deferrals and other adjustments on Form 1099-B. However, **brokers are required** to analyze only identical securities **within a single account** to determine if a wash sale has occurred. Only identical securities are subject to wash sale deferral for purposes of cost basis reporting. **Clients are still obligated** to apply the wash sale rules **across all of their accounts** for substantially identical securities when preparing their tax returns.

What's New for 2012

The 2011 changes will apply to mutual funds, ETFs and DRIPs acquired on or after January 1, 2012. Here's what's new for 2012:

New Form 1099-B. As a result of Phase I changes, brokers will be required to include cost basis, acquisition date, wash sale disallowed loss, covered and uncovered status, and holding period information on Form 1099-B for the 2011 tax year. The revised form will be mailed to your clients by mid-February 2012 and will show cost basis and proceeds for covered equities sold or redeemed in 2011, plus whether the gain or loss is short- or long-term.

We anticipate that the new Form 1099-B will be the biggest source of confusion and questions from clients. Because they may turn to you as their trusted advisor with these questions, you may experience an increase in call volume during tax season. Be prepared to guide your clients through the new form and what it means for them.

Default cost basis methods. For mutual funds, ETFs and DRIPs, brokers can use average cost (with shares sold in FIFO order) as their default method, or specific identification, which can include standing instructions for a cost basis

COST BASIS METHODS

As of January 1, 2011, the IRS default cost basis method used to determine the adjusted basis and gain or loss is First In First Out for equities and average cost for mutual funds, unless another method was already assigned. To use a method other than the default, you must notify the broker that you wish to apply a different permitted method at the time of trade—or establish a standing order on behalf of your client. Depending on your broker, the following cost basis methods may be available for equity trades and taxable gains:

- First In First Out (FIFO)
- Last In First Out (LIFO)
- High cost
- Low cost
- Other tax-optimized methods your broker may offer
- Average cost is available as a default for mutual funds, but may be selected for ETFs and DRIPs as well. Average cost is derived by dividing the total dollar amount invested in a particular fund position by the number of shares held prior to the trade date. When average cost is the default, shares are sold in FIFO order. For mutual funds, it is also possible to indicate specific lots to sell, providing the account is not using the average cost method already.

method. Check with your brokers to determine which default method they will be using for these securities.

Covered and uncovered mutual fund shares.

The key change in Phase II relates to bifurcation, which indicates a mutual fund position with two average costs: one for the uncovered shares and one for the covered shares. Currently held mutual funds will not be covered by the legislation when the second phase takes effect on January 1, 2012, but additional shares of the same fund purchased after the effective date will be covered. These share lots will have to be tracked separately for cost basis purposes. What's more, how brokers will report cost basis for covered and uncovered shares may vary. Bifurcation is a potentially confusing situation that your clients will need to understand.

Average cost method. Another significant development coming with the second phase of the legislation is that your clients who currently use average cost for their mutual funds will be able to move out of average cost to another method by making their request in writing. IRS approval is no longer required in order to change from the average cost method. The starting basis will be averaged at the time of the change, and the average cost method will apply to shares owned at that time. But shares purchased after the change will use the new cost basis method you or your clients have

chosen. It will be important for you to consider which cost basis method to use when you purchase new shares of the fund.

Gifted, inherited and transferred shares. The rules will be the same for gifted, inherited and transferred shares of mutual funds as they are for equities, as long as they are not using average cost. For gifts in accounts that use average cost, if the donor's adjusted basis exceeds the FMV when the gift is made, those shares in the account are not eligible for the average cost method unless the recipient of the gifted shares notifies the broker in writing that the recipient accepts the FMV as the cost of the security going forward and wishes to retain the average cost method.

S corporations will be affected in 2012.

S corporations will become subject to tax reporting on Form 1099-B for covered securities acquired in 2012. Because of this, brokers need to identify whether corporate account holders are C corporations or S corporations. If the broker does not know, it must assume that the account holder is an S corporation subject to mandatory reporting. The new Form W-9 from the IRS provides boxes to identify the type of corporate account holders. Brokers are expected to contact current corporate clients to request a new Form W-9 and to include corporate identification in account opening forms and statements.

PREPARING CLIENTS FOR CHANGES IN 2012

With key changes coming to cost basis accounting for mutual funds, ETFs and DRIPs in 2012, and the new Form 1099-B containing cost basis information on equities sold in 2011, there is potential for client confusion. Consider setting a strategy now for how your firm will handle and mitigate any confusion.

The changes coming to cost basis reporting in 2012 are different and more complex than the ones that took effect in 2011—and communicating with your clients will be all the more important. There are two big issues to address this year: explaining to clients the changes and ramifications of the new Form 1099-B, which will reflect the changes that went into effect this year, and alerting clients about the changes coming to mutual funds, ETFs and DRIPs beginning in 2012.

Help Clients Get Ready for the Updated Form 1099-B

The effects of Phase I changes will be on the top of mind for clients when the new Form 1099-B arrives in early 2012, reporting on equities acquired in 2011. Firms should expect that the arrival of these revised forms—for the first time containing cost basis, acquisition date, wash sale disallowed loss, covered and uncovered status, and holding period information—will likely generate a lot of questions. Even if your clients do not hold any equities, the form will be completely redesigned and may cause confusion. Now is the time to consider adding to and training back-office staff to handle these inquiries in the interest of providing a smooth client experience.

The IRS has issued a final Form 1099-B, and it is not too early to proactively help clients understand what has changed. Even if you have already reached out to clients about the changes to the forms, many will need a reminder as to why they are receiving cost basis information on Form 1099-B and what they are responsible for reporting on their tax returns. And if you or your broker reports cost basis information for uncovered securities as an added value, your clients will need to understand that while this information hasn't been reported to the IRS, they are still responsible for reporting it on their tax returns. Others may not realize that although cost basis on covered securities has been reported to the IRS, they are still responsible for including this information on Form 1040 Schedule D.

CASE STUDY: THE VALUE OF PROACTIVE COMMUNICATION

For The Mutual Fund Store, communication is key. The firm, which offers fee-only investment management at over 70 locations nationwide, has been contacting advisors and their clients to ensure they're ready for the changes.

The Mutual Fund Store®

Location: Headquartered in
Overland Park, Kansas

Type of firm: Money manager

AUM: \$6.5 billion

Focus: Mutual funds

“For the next phase of the legislation, we’ll be doing proactive communications with clients again, talking about the impact of the legislation on mutual funds and promoting the new 1099-B form,” says Barb Blauw, assistant vice president for support operations. Last year, the firm included information about cost basis changes in its third- and fourth-quarter newsletters, and emailed clients at year-end to remind them of the firm’s default method. Blauw said that she anticipates sending similar communications this year.

The Mutual Fund Store also held a webinar last year to educate its advisors about the details of the changes and prepare them for questions from clients, and it plans another in the third quarter of this year.

“One of the things I stressed in the webinar was that once a trade has settled—and mutual funds settle in one day—you can’t retroactively change the cost basis method,” Blauw says. “That’s my biggest concern from a client perspective, because it’s important to have the correct cost basis method noted on the account.”

In general, Blauw says, she and her team have focused on keeping an open line of communication between their advisors and their portfolio management system provider. “It’s important for us in operations to be as proactive as we can and learn as much as we can about these legislative changes—so that we can then lead the way to educate our advisors and communicate with our clients,” Blauw says.

A BENEFIT FOR ADVISORS

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.

“We’re really looking forward to the possibility of using realized gain/loss reporting from our custodians,” says Mark Riley, operations manager and chief compliance officer of The Milestone Group, Inc. “Today we produce these reports out of our portfolio management system. In the future, with our custodians’ data and our portfolio account data in sync, we may not have to produce these reports ourselves. It’s a fairly involved process for us to produce those reports at the end of the year.”

Note that if your broker will not be providing gain/loss information on uncovered securities, you may want to continue reporting it to clients.

“Once a trade has settled—and mutual funds settle in one day—you can’t retroactively change the cost basis method. That’s my biggest concern from a client perspective, because it’s important to have the correct cost basis method noted on the account.”

— *Barb Blauw, The Mutual Fund Store®*

What’s more, brokers will have their own revised Form 1099-B, and if you work with multiple brokers, your client will receive cost basis data in multiple ways. Some brokers will report cost basis on uncovered securities to clients as a courtesy, but others may not. Check with your brokers for a preview of the form(s) your clients will receive. To minimize confusion and repetitive calls, consider developing a summary sheet to educate clients on how to read the information on the new Form 1099-B and where they will need to put it on Form 1040 Schedule D.

If your firm has established relationships with your clients’ tax advisors, think about contacting them directly to discuss the new cost basis requirements. This communication can help provide a more consistent experience for your clients and can ensure that their tax advisor is fully up to speed on the changes.

Communicate Phase II Changes

Just as you may have reached out to clients last year about the changes to equities, your firm should consider communicating about the changes to mutual funds, ETFs and DRIPs, which will become covered by the legislation beginning January 1, 2012.

Brokers will be communicating directly with investors about the upcoming changes. In particular, if you work with multiple brokers, or if some of your clients work with more than one advisor, those clients may receive different information from different sources.

Consider developing a plan to get ahead of those communications and talking to your clients first. Proactively reaching out to your clients can help to balance these discussions and to reduce any confusion they may have about the changes. Consider how you will educate staff on the details of the legislation

and its implications for investors. Training tools, such as webcasts on the topic, can help everyone at the firm provide a consistent, knowledgeable experience for clients.

Changes Related to Average Cost

Some brokers have elected to use the average cost method as the default. Clients can revoke the average cost default retroactively dating back one year from the date of revocation or to the date of the first sale, whichever date occurred most recently. Clients who do not wish to have average cost applied to their account should be proactive in selecting another method when they open a new account or acquire shares.

If a client currently has accounts that use a method other than average cost, those accounts will continue to use that method even if the broker has chosen to default to average cost. However, the ability to change to another method going forward is good news for clients, bringing more options for those who prefer not to average the cost of their shares.

Flores recommends:

- Helping clients understand how the rules have changed relating to average cost.
- Communicating what your broker or multiple brokers' default methods are, and what the consequences are of having that default method apply to the account.
- Helping clients understand how to select a cost basis method other than the broker's default.

Try to Anticipate Client Needs

Clients will receive their first Form 1099-B with cost basis data on covered equities in early 2012—but some of your clients may want to access cost basis information for all securities,

regardless of whether they are covered by the legislation. Still others may want cost basis information more frequently than just at tax time. Plan how—and if—your firm will address this client need:

Does your broker offer gain/loss reports?

Many brokers report gains and losses and cost basis data on monthly account statements as a value-added service. This feature can help provide clients with the information they need to report cost basis information to the IRS for uncovered or pre-effective-date securities.

“My concern is that clients that hold mutual funds in particular have been accustomed not to worry about cost basis until they redeem shares and file their tax returns. It would be in the best interest of advisors to consider communicating the new information about average cost to clients so that when clients redeem covered shares they are not surprised by the amounts reported on Form 1099-B for that redemption.”

— *Deanna Flores, KPMG*

Find out if your brokers plan to include cost basis information for uncovered securities as a courtesy on Form 1099-B. If they do, this will be of great help to your clients in preparing their tax returns. If they do not, consider whether you want to provide this information to clients in the form of gain/loss reports.

Can you or your broker offer online account access? Many brokers' websites are set up to provide cost basis data to your clients. Consider enrolling interested clients in this service.

THE IMPORTANCE OF TALKING TO CLIENTS NOW

The complexity of the legislation may create concern among clients—especially because of the new changes to the Form 1099-B and average cost rules. While some may call their tax accountants with questions, advisory firms should be prepared for an increase in call volume—either from clients directly or from their CPAs. Clients might raise these issues:

Questions about Form 1099-B. When clients receive Form 1099-B in early 2012, they will see cost basis information for any equities they bought and sold in 2011—but they will not be able to make any changes to the cost basis method used for each trade, which could lead to confusion or frustration. They also may not understand why the cost basis information for uncovered equities may not be reported on their 1099-Bs.

Lack of understanding about cost basis. Brokers will use their default method for determining adjusted cost basis and gain/loss unless you or your client notifies the broker directly to change it. Communicate the importance of working with you to decide the best method, so that you can help your clients minimize their tax burden throughout the year. This is also an opportunity for you to work jointly with your clients' CPAs and tax advisors to create a holistic experience for clients.

Uncertainty regarding the new average cost rule. The changes to the average cost method—particularly if your broker uses average cost as its default—represent a significant shift in the way investors and their clients approach selecting a cost basis method for mutual funds, ETFs and DRIPs. Be prepared to clearly explain the new rule and its ramifications to your clients—or else they may not get the outcome they expected when they redeem a share.

Confusion about covered holdings. Because the new rules roll out in three phases, applying only to new securities acquired on or after those staggered dates, some clients may be unsure of which transactions are covered and which are not. And because brokers will be reporting to the IRS for covered securities, you can help make tax preparation easier for your clients by providing them with cost basis information for uncovered securities.

Concern about account transfers. Securities transferred from other brokers after the legislation's effective date will need to come with a transfer statement that includes cost basis information. Clients may call you with questions about whether the cost basis information was properly moved. If it wasn't, the security will be considered uncovered, and only the client will be responsible for determining and reporting cost basis on that holding.

ADDRESSING BACK-OFFICE ISSUES

Even if you prepared last year, you still have to take steps to be ready for the next phase of the legislation. If your firm hasn't yet taken action, now is the time to plan. Assess how the next phase of the legislation will affect your firm, and begin training staff now to prepare.

Consider the areas where your firm's back office will be affected.
For example:

Cost basis default methods. Be sure you know your broker's default methods and think about whether you wish to use a method other than your broker's default for determining gain/loss for clients' mutual fund, ETF and DRIP shares. Examine the varying needs of your clients and plan how you will address them. For example, if your broker is using average cost as the default for mutual funds and DRIPs, would some of your clients want to change their default to another method? If you think most of your clients would prefer to use average cost, consider whether to reach out to some of your more high-touch clients who may prefer greater flexibility.

Data downloads and reconciliation. If you haven't already implemented workflow changes and reconciliation processes, assess whether you need to add a step to your firm's back-office workflow to ensure that there are no discrepancies between your cost basis information and your broker's. If clients report cost basis information on their tax returns that differs from what was reported on Form 1099-B, the IRS could take notice.

Lori Dierke, operations manager at Accredited Investors Inc., recommends double-checking with your brokers that any cost basis information you've uploaded has been correctly received and recorded. "We found that immediate follow-up helped us to catch errors," she says.

Transfers. Covered shares that are transferred after the effective date will be sent from the transferring broker to the receiving broker with cost basis information, and transfer information will appear in data downloads.

Gifted and inherited shares. Gifted shares must be identified and applicable accounting rules applied to the gain/loss. Additionally, in the event of an account holder's death, the regulations require brokers to flag assets in the account as inherited. Brokers will generally step up the basis using the FMV of the securities on the date of death. If you have a client whose estate chose to value using the alternate date of death, an authorized representative of the estate may notify the broker to value the security using the alternate date.

“I expect that once mutual funds become covered by the legislation, our processing time will increase each day.”

— *Barb Blauw, The Mutual Fund Store®*

“We’ve found that some firms are saying, ‘If I had to do it over again, I would have started earlier.’ With some of these issues, you don’t really know what you don’t know until you roll up your sleeves to do it.”

— *Deanna Flores, KPMG*

Corporate actions. The cost basis information that your brokers report on Form 1099-B must be adjusted for corporate actions—which may vary by broker.

Wash sales. Although brokers will report cost basis information for all wash sales involving identical securities within an account, investors must report wash sales occurring across all of their accounts. Some brokers may accept customer-provided information for those other wash sales. Understand your brokers’ policies so you can help your clients track sales for which they are responsible.

Reclassifications. The cost basis information that your brokers report on Form 1099-B must be adjusted for return of capital payments, which may occur after year-end based on information released from the issuer.

Stay up to date on your brokers’ plans for complying with the legislation, including technology upgrades that may have implications for your back office. Pay special attention to the default method they choose, and watch for the new Form 1099-B when it becomes available. Even if you need more information from your brokers before you move forward, now is the time to evaluate how your firm may be affected and determine what unknowns remain.

CASE STUDY: PAVING THE WAY TO A SMOOTH TRANSITION

A fee-only wealth management firm, Accredited Investors Inc. primarily uses a mutual fund strategy for clients' portfolios. Even so, the firm paid close attention to the first phase of the legislation, which covered only equities, and began preparing early in 2010. According to Lori Dierke, operations manager for the firm, those preparations paid off: The transition to the new tax reporting environment "was much better than I had expected," she says.

Accredited Investors Inc.

Location: Edina, Minnesota

Type of firm: Wealth manager

AUM: \$948 million

Focus: Mutual funds

"One of the big things we focused on was missing cost basis on tax lots," Dierke says. "We wanted to make sure that when we uploaded our data to our custodians, our information was as complete as possible. The goal was to reduce the reconciliation process going forward."

As part of its preparations, Accredited tuned in to webcasts to keep up with news and developments and maintained communications with custodians and their portfolio management system provider to stay up to date on the latest technology releases. Dierke says she expects to continue to do the same as the second phase of the legislation nears, especially because it will affect her mutual fund-focused firm more than the last phase did.

Although few of the firm's clients have expressed concern about the changes so far, Dierke expects that to change when they see the new Form 1099-B in 2012. "I think their reaction could be all over the board," she says, "from great anxiety, to considering it a non-event and anything in between, depending on their involvement with income tax preparation."

One big issue her firm is still trying to resolve is managing the reconciliation of wash sales triggered by dividend reinvestments. "Most of our clients hold mutual funds that pay out dividends at year-end," she says. "We're expecting that if you don't have a solution or better fix, it will be even more difficult to handle the volume this coming year-end."

OPPORTUNITIES

The changes resulting from this legislation offer several potential benefits for both firms and their clients. For advisors, these changes create the opportunity to build loyalty, consolidate client assets and, for those who do not do so already, offer tax-efficient investment strategies. Clients, for their part, will have access to accurate information that allows them to see the tax consequences of their trades immediately—and the new information reported on Form 1099-B will simplify tax preparation for clients.

Potential Opportunities for Advisors

Build loyalty. By helping to guide clients through the new cost basis reporting laws, advisors stand to enhance their value to their clients. Moreover, for advisors who have clients with multiple advisors, this is an opportunity to demonstrate the value of working solely with them. For instance, firms that offer gain/loss reports for their clients' covered and/or uncovered securities may gain a competitive advantage over those who do not.

“Advisors who communicate early and clearly about the cost basis reporting changes and how they will affect their customers stand to build trust and enhance their customer relationships,” says Deanna Flores of KPMG.

Consolidate clients' assets. Your clients will receive Forms 1099-B from all of your firm's brokers with whom they have accounts. And if clients work with multiple advisors, this experience could be complicated. Use this opportunity to talk to your clients about consolidating assets with your firm, which can help make tax preparation simpler and more accurate.

Offer tax-efficient investment strategies to clients. If your firm does not already provide tax-efficient investment strategies, now may be a good time to implement them. With real-time cost basis information, your firm may be better positioned to make recommendations on what lot to trade based on a client's tax situation.

Build relationships with CPAs and tax advisors. The coming changes present an opportunity to reach out to your clients' CPAs and tax advisors. By connecting with them, your firm can help create a more

holistic investment and tax-planning experience, using the revised Form 1099-B to include tax impact in assessing clients' financial picture.

Mark Riley, operations manager and chief compliance officer of The Milestone Group, Inc., says his firm has primarily targeted its communications about cost basis legislation toward its clients' CPAs. "The vast majority of our clients use professional tax advisors," Riley explains. "So, last year our strategy was to communicate directly with their tax advisors whenever possible."

Riley says that this year, his firm will look for opportunities to reach out to tax advisors, such as sharing an example of the new Form 1099-B.

HOW THE LEGISLATION CAN BENEFIT YOUR CLIENTS

It makes tax preparation easier. The legislation eases the burden of cost basis reporting for investors.

It can help give clients more information about their total tax picture. Many custodians are planning to make available real-time information about the tax consequences of a trade. This will help clients to have a more informed view of their total tax picture. Clients who work with non-discretionary advisors and place trades themselves will be able to compare the tax consequences of different cost basis methods.

It minimizes year-end surprises. Your clients will be able to see the effects of a trade on their tax impact—and make changes—as positions are sold.

"Proactively communicating with our clients' tax advisors is a way we can add value to our clients."

— *Mark Riley, The Milestone Group, Inc.*

CONCLUSION

Adjusting to the new cost basis reporting requirements will require planning, and those advisory firms that remain committed to easing the transition for clients stand to build relationships and reinforce value. The sooner firms begin to think critically about how the legislation will affect both clients and their back offices, the better prepared they will be when the second phase begins on January 1, 2012.

KEY TAKEAWAYS:

- The second phase of this legislation is more complex than the first, particularly as it relates to the client experience and guiding clients through the intricacies of the legislation. Anticipate that the new Form 1099-B and other changes coming in 2012 may create confusion for clients. Plan now to develop a communications strategy to guide clients through these changes in 2012.
- Preparing your back office now for the second phase is critical. Although brokers shoulder most of the burden to comply, your firm should begin to get ready for workflow changes and client questions. Staying on top of news from brokers is vital to preparing the back office.
- Taking steps now to prepare your firm and your clients can lead to stronger client relationships and can help avoid difficult workflow issues later. Proactively communicating with clients will be key to uncovering potential opportunities.

APPENDIX: FIRMS INTERVIEWED

We thank the firms listed below for their participation and for the insight they shared during interviews for this project.

| | |
|----------------------------------|------------------------------|
| Accredited Investors Inc. | Edina, Minnesota |
| KPMG LLP | San Diego, California |
| The Milestone Group, Inc. | Denver, Colorado |
| The Mutual Fund Store® | Overland Park, Kansas |

APPENDIX: SAMPLE CLIENT POSITIONS

This chart shows a sample of a client's positions as of June 30, 2012.

| HOLDINGS | QUANTITY Units purchased | MARKET PRICE Cost per share | MARKET VALUE Cost basis | ASSETS ACQUIRED | UNREALIZED GAIN (OR LOSS) | HOLDING PERIOD |
|-------------------------|--------------------------------|-----------------------------------|----------------------------|--------------------|------------------------------|-------------------|
| IBM | 600 | \$26.00 | \$15,600.00 | | (\$2,400.00) | |
| <i>Equity</i> | 600 | \$30.00 | \$18,000.00 | 2/26/2001 | (\$2,400.00) | Long-term |
| General Electric | 4,050.00 | \$102.53 | \$415,246.50 | | \$11,320.00 | |
| <i>DRIP</i> | 1,850.00 | \$100.05 | \$185,092.50 | 3/25/2012 | \$4,588.00 | Short-term |
| | 2,200.00 | \$99.47 | \$218,834.00 | 5/10/2011 | \$6,732.00 | Long-term |
| GE cost basis | | | \$403,926.50 | | | |
| ABC | 2,000.00 | \$125.3846 | \$250,769.20 | | \$52,769.20 | |
| <i>ETF</i> | 2,000.00 | \$99.00 | \$198,000.00 | 5/20/2011 | \$52,769.20 | Long-term |
| XYZ | 7,000.00 | \$81.252 | \$568,764.00 | | \$88,696.40 | |
| <i>Mutual fund</i> | 3,000.00 | \$67.2234 | \$201,670.20 | 5/15/2012 | \$42,085.80 | Short-term |
| | 3,500.00 | \$70.2564 | \$245,897.40 | 5/12/2005 | \$38,484.60 | Long-term |
| | 500 | \$65.00 | \$32,500.00 | 2/26/2001 | \$8,126.00 | Long-term |
| XYZ cost basis | | | \$480,067.60 | | | |
| TOTAL COST BASIS | | | \$1,099,994.10 | | | |

- Covered securities under the legislation and therefore reportable to the IRS by Schwab once sold
- Uncovered securities and therefore reportable to the IRS by the account holder (taxpayer) once sold

For an explanation of covered and uncovered securities, see page 3.

For illustrative purposes only

APPENDIX: SAMPLE FORM 1099-B

 CORRECTED (if checked)

| | | | | |
|--|-----------------------------------|---|---|---|
| PAYER'S name, street address, city, state, ZIP code, and telephone no. | | 1a Date of sale or exchange | OMB No. 1545-0715 2011 Form 1099-B | Proceeds From Broker and Barter Exchange Transactions |
| | | 1b Date of acquisition | | |
| | | 2 Sales price of stocks, bonds, etc. \$ | Reported to IRS } <input type="checkbox"/> Sales price } <input type="checkbox"/> Sales price less commissions and option premiums | |
| PAYER'S federal identification number | RECIPIENT'S identification number | 3 Cost or other basis \$ | 4 Federal income tax withheld \$ | Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported. |
| RECIPIENT'S name | | 5 Wash sale loss disallowed \$ | 6 If this box is checked, boxes 1b, 3, 5, and 8 may be blank <input type="checkbox"/> | |
| Street address (including apt. no.) | | 7 | 8 Type of gain or loss Short-term <input type="checkbox"/> Long-term <input type="checkbox"/> | |
| City, state, and ZIP code | | 9 Description | | |
| Account number (see instructions) | | 10 Profit or (loss) realized in 2011 on closed contracts \$ | 11 Unrealized profit or (loss) on open contracts—12/31/2010 \$ | 14 Bartering \$ |
| CUSIP number | | 12 Unrealized profit or (loss) on open contracts—12/31/2011 \$ | 13 Aggregate profit or (loss) on contracts \$ | 15 If box checked, loss based on amount in box 2 is not allowed <input type="checkbox"/> |

Form **1099-B**

(keep for your records)

Department of the Treasury - Internal Revenue Service

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