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Automated CBR Software Helps Investors Count Their (Tax) Losses

In May, the IRS delayed the implementation for cost-basis reporting for fixed-income instruments—but shoring up financial firms' tax knowledge and solutions should be done now.

The US Internal Revenue Service's deadline for cost-basis reporting for fixed-income debt instruments has been delayed for a year, but that doesn't mean firms can afford to postpone their preparations for the new requirements. Automated software solutions can help brokers plan how to properly harvest allowable tax losses by structuring deals using different products and avoiding banned offsetting trades, and can help identify outstanding disallowed losses already incurred to execute a trading strategy to harvest those before the calendar year's end.

Taxes are not popular or particularly sexy. US president George H.W. Bush—who famously promised no new taxes, and then lost his bid for a second term after reneging on that oath—knows better than most that they can become a political third rail. But it is hard to deny their prominence as heavily indebted governments continue to develop strategies to claw back revenue, with the financial centers in those countries an easy target.

French president François Hollande, too, has learned the hard way that so much as making a campaign issue of higher taxes for the ultra-wealthy will lead to increased flights of personal wealth, either into offshore accounts or investments—indeed, London's Kensington real estate brokers are counted among the unintended beneficiaries of the French election.

Meanwhile, the drive to establish a pan-European financial transaction tax has progressed in fits and starts; German chancellor Angela Merkel recently warmed to the idea as a stipulation for bailout funding, while the UK's coalition government says it will block all efforts at implementing the idea unless it is adapted globally.

On the other side of the Atlantic, the IRS delayed by a year the date for required implementation of CBR for fixed-income debt instruments, which had been set to go into effect in July as part of a broader program to recoup $6.7 billion in revenue, a figure estimated by the Joint Congressional Committee on Taxation.

George Michaels
G2 Fintech

The requirement, which was legislated in 2008 as part of the Emergency Economic Stabilization Act—along with the Troubled Asset Relief Program bailout measures—is fairly simple on paper: Brokers and services providers like investment management firms must calculate and report to clients the taxable value of the securities they hold. While those calculations are relatively simple for equities, they become more complicated for mutual funds and exchange-traded fund (ETFs)—for which CBR was implemented earlier this year—and still more tricky for derivatives.

"Once you get into complex structured products, all sorts of things can happen," says George Michaels, CEO at financial tax software provider G2 Fintech. "For example, a client might hold a variable rate knockout option: If the option knocks in or out, does it constitute the same security as the underlying variable rate note?" That becomes important because, since passage of the Revenue Act in 1921, investors are prohibited from holding offsetting positions on "substantially identical" securities, known as a wash sale, because the trades represent a zero-risk scenario and, potentially, can be initiated purely to write off the losses.

Michaels, who worked for several years as CTO at hedge fund Carlson Capital as well as at Goldman Sachs and Tudor

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Investment Corp., says that funds and the sophisticated sell-side firms have been using software to "proactively" monitor, and reduce, the tax liabilities of their clients for some time. Yet the cost-basis reporting delay, which was precipitated with a request to the IRS by major brokers State Street, BNY Mellon, and Northern Trust, would also indicate that some firms, even larger ones, are not yet comfortable with fixed income—either because they haven't achieved the capacity to do so, or simply don't want the added cost or risk of assessing more nuanced products.

And even while the extra year buys those firms some time and saves some cash, the CBR delay doesn't address the broader issue around tax and finance. Indeed, it may just prolong industry-wide ignorance. Managers don't know which losses can be attributed for tax purposes and which transactions, intentionally or not, initiate an illegal "tax shelter."

Part of the reason for this, which Michaels and G2 senior software developer Daniel Tilkin note this week in a white paper, is the intentional definitional ambiguity surrounding the language in the internal revenue code (IRC), and the piece-meal way the IRS has clarified those terms through tax court precedents, purposely creating a lot of gray area within which both firms and the IRS negotiate. Rather, the authors suggest a different paradigm, based around a doctrine of "economic substance" borrowed from market risk management, might make paying taxes less tedious, especially where fixed income is involved, because today it would be almost impossible to manage manually.

"Wash, constructive, and short sales are very difficult to get right, and throwing in derivatives can get very ugly, fast. Convertible bonds are one example. Another even simpler example is known as a straddle: You might buy a put-option on Facebook stock for $20, essentially guaranteeing that if the stock tanks, you can get out at that price. Of course, if the stock climbs, you're losing money on the puts, and having bought potentially thousands of them as insurance, one would think you could declare those as losses on your taxes and reduce tax obligation. But under IRC Section 1092, what you technically executed is a straddle. You can't take those losses immediately—you have to wait until you sell off your position," says Michaels.

Automated solutions that harvest allowable tax losses and identify outstanding disallowed losses already incurred always need to be more intuitive, Michaels says.

"Support for 'paydowns' and 'payups' on asset-backed bonds are one of the important modifications we're developing right now, as well as support for different kinds of return-of-capital transactions," Michaels says. He says he anticipates greater demand for fixed-income reporting running up to the CBR implementation next year. Even so, further delaying into a fifth year CBR for derivatives was, to Michaels, a mistake for all involved, whatever the complexity.

"Taxpayers would be getting cost basis to help pay their taxes more easily. The IRS benefits with increased revenues, estimated by Congressional research to reach $6.8 billion; firms grow their knowledge and would be forced to deal with it now; and Congress gets an easy win, filling government coffers without really 'raising' taxes," he says.

But where finance and tax cross, even what seems easy and straightforward is often anything but. ■

—Tim Bourgaize Murray

THE BOTTOM LINE

- Even while the financial industry resists movements to introduce further taxation, some rules already in place to limit the attribution of losses require attention as requirements around cost basis reporting for complex instruments come into effect; mutual funds and ETFs this year, and fixed income instruments next.
- Automated solutions will be required to monitor both which losses related to securities traded are attributable to tax obligations, and how sophisticated hedging transactions can be assembled to avoid wash sales and other prohibited structures.