UNDERSTANDING DIFFERENCES BETWEEN 'SECURITIES REGULATORY COST' AND 'TAX COST'

As an advisor, you'll have heard the terms 'cost', 'original cost', 'book value', 'tax cost', 'book cost', 'average cost' and 'adjusted cost base' often used interchangeably. Until now, this may not have been much of an issue. With new CRM2 requirements taking effect December 31, 2015, it's important to know how these words may be used.

New CRM2 'Securities Regulatory Cost' *(see over for new CRM2 definitions[i] you should know)*
As of December 31, 2015, securities regulators require financial institutions they regulate to report securities regulatory position 'cost' – either 'book cost' or original' cost as defined[i] – for each security that investors hold. A good number of dealers regulated by the Investment Industry Regulatory Organization of Canada (IIROC) already report such information. Most dealers and other financial institutions offering securities will report 'book cost', but some may report 'original cost' instead. Comparing either cost with the market value of each security will now give all investors a rough measure of the performance – or return – on each security[ii]. As 'securities regulatory cost' and 'tax cost' may differ, be ready to answer client questions.

'Tax Cost' *(see over for Canada Revenue Agency (CRA) and Revenue Quebec (RQ) 'tax cost' terms[iii] to know)*

In the past, account statements of some clients may have shown, beside the market value of their securities, a column of numbers, often under the heading of 'book value' or 'average cost', as an extra service. Until limits on the percentage value of foreign securities that could be held in registered plans (such as RRSPs) were removed in 2005, Canadians could use this information to make sure they didn't have to pay tax penalties on excess 'foreign content' within such plans. The 'book value' column also would give clients a general idea of what they were earning on each security.

The 'book value' could be the amount clients need to calculate capital gains or losses for tax purposes when selling their securities, but at other times it would not be. If the tax cost used to calculate a capital gain or loss were too low, the gain would be higher than it should be (or the loss would be lower), and the client would pay too much tax. If the tax cost used were too high, the client would be under-reporting a capital gain (or over-reporting a capital loss).

That's why dealers usually include a warning that clients should validate a security's cost against their account statements, trade confirmation slips and other records before using the information to complete their tax return. On the next page are some of the reasons you or your firm may not be able to provide all the tax information clients need for CRA (and, for Quebec residents, RQ) purposes[iv]. Revenue Quebec just issued a notice reminding clients they may need to refer to information on, and keep, statements, confirms and other documents they receive from their financial institutions.

What's the difference between 'securities regulatory cost', 'tax cost' and what's been reported before?

In some cases, there will be no difference, in others there may be only a slight difference, while in still others the difference will be substantial. Find out if your firm will be reporting on an 'original cost' or 'book cost' basis. This is important because while we think most dealers regulated by IIROC will report on a 'book cost' basis for securities regulatory purposes, other dealers and portfolio managers may not.

1. A small number of clients may have made certain types of tax elections or have personal tax situations that do not meet the CRM2 securities regulatory definition (however, elections clients make if holding the stock of a company undergoing a corporate action, such as a merger, do meet the new definition). If immaterial, it is likely there will be no issue. **Speak to your firm about this**.
2. When financial institutions haven't had enough information to report the 'cost' of securities in the past, account statements might display N/A – not available. After December 31, 2015, dealers must replace N/As under a 'book value' title with the security's market value and a footnote/notice. **Check with your firm if you can accept confirmation/statement copies from past dealers to complete clients' cost records.**
3. If a client is used to making updates to his or her cost numbers through your discount broker, this may no longer be possible. **Ask your firm how your clients who have online holdings may be affected.**
4. If your firm reports 'book cost', and a client also has an account with a portfolio manager reporting on an 'original cost' basis, the cost of any security bought on the same day at both firms – one reflecting reinvested dividends or return of capital – will differ although the return will be the same. **Statements must include a note showing if securities regulatory 'cost' is 'original cost' or 'book cost'.**

Definitions and Explanations

New CRM2 'Securities Regulatory Cost' Terms

- **'Original cost'**: The amount a client pays to buy a security, including transaction fees (or net of these charges if they are 'short' the security).
- '**Book cost'**: The original cost of a security, increased by reinvested dividends or other 'distributions', or adjusted by returns of capital (the return of part of the client's original investment or receipt of other non-cash distributions of value), and adjusted by corporate reorganizations such as mergers (in the case of a 'short' security, the definition is altered accordingly).
- **'Position cost'*:*** Either 'original cost' or 'book cost – each dealer must use only one way to report 'cost' for securities regulatory purposes and this must be reflected and defined on account statements.

[ii] **New Performance Report:** IIROC dealers also are developing a new total performance report, capturing the rate of return on the client's overall account, to be launched within the next year or so. Neither 'tax cost', nor 'securities regulatory cost', is part of the performance, or rate-of-return, calculation: only the value when a deposit or contribution is made (adjusted by the value of withdrawals and dispositions) and the market value of the holdings when the money-weighted rate of return is calculated.

[iii] **'Tax Cost' Terms:**

Note: *We are using 'tax cost' as a short colloquial expression, which could mean 'cost or book value' (the term on the CRA T5008 or RQ RL-18 slips or equivalent summaries), 'adjusted cost base (ACB)', or 'average cost', but remember it may not be what a client needs to complete his or her tax return.*

- **'Cost or book value':** Initial outlay or price a client pays for a particular investment, including commissions or fees.
- **'Adjusted cost base' (ACB):** 'Cost' of an investment, adjusted by transactions such as reinvested dividends, return of capital, or corporate actions such as mergers. For identical properties such as mutual funds, ACB is averaged. That is, the total ACB is divided by the total number of shares or units the client owns. If a client sells all holdings of a particular security, the market value he or she receives (net of fees), less the ACB of all the securities, will give the client his or her overall gain or loss.

Note: *These CRA and RQ terms should not be confused with 'cost basis' or 'average basis' – U.S. Internal Revenue Service (IRS) 'tax cost' approaches that differ from Canadian tax rules.*

[iv] **Reasons why it may be impossible for dealers to have the right 'tax cost' information:**

For example, if the securities holdings:

1. Have a cost that reflects incomplete information due to the late receipt of or change in relevant data from/by security issuer(s) (e.g., the current year pre-sale return of capital that should be reflected in adjusted tax cost rarely will be known before T3s are completed by issuers two or three months into the next tax year)
2. Were bought many years ago before fees were tracked as part of the 'cost'
3. Were transferred from another financial institution(s) that may not have had the correct 'cost'
4. Were issued by a limited partnership later re-assessed taxes affecting the cost of holdings.

Also, dealers may not know about information that affects a client's particular tax cost in certain other cases:

1. When the client has holdings of the same security at another brokerage and must take tax cost of both into account when he or she calculates adjusted cost base
2. What a client may have elected for tax purposes or there is a client-specific factor leading to an adjustment
3. When assets are transferred from one financial institution to another and the receiving institution may be required to set the cost to the current market value under securities regulatory requirements
4. When a capital loss is denied as being a "superficial loss", but the loss is added to the tax cost of repurchased shares.