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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Out of the Shadows: The Rising Relevance of Industry Tax Reporting

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Investment dealers fulfill many important functions to support capital markets, public policy, and investors. This paper focuses on one such function – tax reporting.

Typically buried deep within dealer middle offices and seldom talked about, tax reporting has become increasingly more complex, burdensome, and relevant and, therefore, worthy of the industry's increased attention.

Canadian investment dealers, including full-service and online firms, collectively administer an estimated 14 million accounts on behalf of their clients. These comprise conventional accounts as well as specialized tax-assisted programs. Activity in these accounts invariably demands that dealers collect and analyze vast amounts of data to properly identify clients and to determine the taxes payable on the returns on client investments—in terms of income, dividends and capital gains—and to provide the tax documentation filed by the taxpayer client. This culminates in the delivery of millions of tax slips each year to clients with corresponding information relayed to tax authorities. While carrying out this function, dealers also take on tax withholding and remittance responsibilities for the direct benefit of government coffers.

Dealer tax reporting, therefore, is critical in administering the government's tax policy objectives and ensuring investors understand the tax implications of their portfolio decisions while equipping them with the information they need to accurately calculate and pay taxes owed.

However, the industry's tax reporting function has come under significant strain in recent years. Increased client demand for more timely tax information, ongoing changes in tax treatment of different financial assets and the creation of tax-assisted programs, such as Tax-Free Savings Accounts (TFSAs,) Registered Disability Savings Plans (RDSPs) and Individual Pension Plans (IPPs) has added complexity to dealer operations. New international reporting of financial transactions of foreign citizens in Canada through regulations such as the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) has also required investment in systems and staff. Moreover, dealer reporting of financial investing has been subjected to increased government scrutiny for tax avoidance.

In sum, increased government requirements and more complicated tax reporting obligations, combined with mounting client service expectations, have significantly increased the resources dealers have had to devote to this area of their business. Shortcomings with existing systems and processes has also exposed dealers to increased financial and reputational risk.

To ensure compliance when carrying out the necessary tax reporting on client investments, while simultaneously maximizing operational efficiency and meeting stakeholder needs, investment dealers must develop a comprehensive strategy for supporting their tax reporting operations.

THE MOUNTING CHALLENGES

The industry's "Tax Reporting Season", which typically runs from January to April, is a chaotic time of year for dealers. The flurry of activities within prescriptive deadlines requires many firms to onboard temporary workers and for some permanent tax staff to work extended hours.

However, industry trends such as online client account access and comprehensive tax planning services, now popular among wealth advisors, has resulted in the need for more real-time access to tax information by stakeholders. Dealers, therefore, must now support their tax reporting function year-round including electronic access to tax slips, cost-basis information, and tax planning tools. In addition, enhanced tax compliance requirements and growing volumes of data have required the processing of more information within shortened cycles increasing the risk of errors, penalties, and costly corrections.

At the heart of the issue for industry is the need for timely, complete, and reliable data. Anything less exposes dealers to various risks (reputational, audit, financial, legal, and regulatory) and unnecessary expense. Unfortunately, the information dealers often require carrying out their tax reporting duties may reside in different places and in varying forms requiring staff to undertake inefficient manual processes to source and scrub the necessary information. Data that is not efficiently collected and stored may require dealers to repeatedly reach out to clients with information requests that risks distancing clients from the firm.

Punitive tax enforcement measures including penalties, forced account closures, or increased levels of tax withholding, combined with aggressive tax audits have also substantially increased the risk for dealers. The client service impact of sending out inaccurate tax slips or withholding incorrect amounts further compounds the precarious situation for dealers.

Looking ahead, it is unlikely that these stresses will dissipate. Client service expectations will rise, policy makers will continue to utilize tax programs for income distribution, governments in search of votes will potentially look to new tax incentives and programs to support constituents, and dealer tax reporting will likely face more, not less, scrutiny from tax authorities.

All this provides a convincing case for senior executives to take increased interest in their firms' tax reporting operations and develop a comprehensive strategy for identifying and addressing current gaps.

CONSIDERATIONS FOR A SUCCESSFUL STRATEGY

Implementing a successful tax reporting strategy first requires strong buy-in from senior management. Executives need to acknowledge that tax-reporting, perhaps long considered solely a cost centre at the firm, has now transformed into a critical part of the firm's service chain. Clients can be gained, and lost, as a result of how the firm executes this service. Other stakeholders, such as the firm's advisors, will also have an interest in ensuring the firm's success in this area. The firm must, therefore, devote its resources and attention accordingly. Furthermore, because tax reporting touches on many parts of the business it will require a firm wide commitment with championing from the top.

Firms must next decide what they want to achieve. Aspirations will vary, but at a minimum all firms should strive for increased operational efficiency to meet their growing tax processing and reporting requirements. This requires firms to accurately measure their existing tax operations costs and identify key dependencies and cost-drivers. For example, corrections can be one of the costliest components of tax reporting, consuming resources, exposing the firm to potential penalties and alienating clients through the delivery of amended tax slips. Lowering correction rates is something that should be pursued industry wide.

Firms should also consider their tax reporting function an integral part of their overarching client-service strategy. Whether through improved reporting directly to clients or empowering advisors with the information necessary to enhance investment returns through tax-related strategies, tax reporting can help differentiate the firm from its competitors. This may require firms to canvass the landscape to see what tax reporting information and front-end services are currently being offered elsewhere and how are they being delivered. The bar has already been set high, particularly by innovative on-line firms that provide clients with 24/7/365 access to real-time information and tools. Firms that service multiple client wealth segments may require separate tailored tax reporting approaches for each, though the basic principles of timely and reliable data must remain common to all.

Firms must next assess their existing capabilities and contrast it to their objectives. This will require firms to undertake a front-to-back analysis of their current staff, systems and processes to identify gaps preventing them from meeting their goals. Key questions that should be considered include whether the firm's existing technology is adequate, and whether existing staff have the requisite set of skills (especially if the firm were to lose a key member of their tax reporting team)? If the answer to one or both of these questions is "no", then the firm must make some important decisions. Major systems and/or staffing changes can be costly and disruptive and should be weighed against alternatives such as partnering with an external service provider to help fulfill the firm's tax reporting activities. Larger firms that handle vast amounts of tax information and client data may even want to explore utilizing machine learning or Artificial Intelligence (AI) to support their tax reporting function.

The most challenging step of any plan is implementation. The focus here once again rests on ensuring the accuracy, timeliness and completeness of data and avoiding unnecessary duplication. This also entails coordination among various internal business groups such as operations, tax, and IT to centralize and streamline processes. Validations need to be embedded throughout the tax reporting process to support data quality and prevent costly errors or penalties. Various teams from within the firm will need to feed into the tax reporting function. For example, what procedures can firms adopt during their client onboarding to safeguard from missing or incorrect client tax identification numbers (a common cause of tax reporting errors), or what role should account transfers staff play in securing accurate cost-basis information for recently acquired accounts?

Once the firm implements its tax reporting strategy there are several ways in which it can measure success. The simplest is to solicit feedback from clients and internal stakeholders such as the firm's advisors or sales assistants. Alternatively, the firm can look to several suitable metrics – has the firm reduced their number of corrections, is the firm receiving fewer tax reporting client complaints, or has the firm been able to avoid the costly penalties of the past?

WHAT IS THE IIAC DOING TO HELP MEMBERS?

The IIAC has been engaged on industry tax reporting issues since its inception. Working closely with members our agenda encompasses the following:

ADVOCACY

The IIAC has successfully advocated for changes, postponement or elimination of various tax reporting requirements deemed unnecessary or problematic for industry. For example, changes to government prescribed tax slips can prove challenging for the industry to implement when not provided with enough lead time to make the necessary system changes. The IIAC has pushed back on such changes, helping members avoid risk of non-compliance and penalties.

The IIAC also participates in regular dialogue with Canadian and international tax administrators providing important industry views on matters impacting tax reporting. Our message to administrators has been consistent: the Canadian securities industry plays a critical role in the successful implementation of any planned government changes to tax reporting and, therefore, our perspectives matter.

BEST PRACTICES

The IIAC, through our Tax Reporting Committee, provides a forum for members to discuss current issues impacting tax reporting operations. Industry best practices are considered on a wide range of matters including reporting, withholding, and cost-base determination. Members openly exchange views on recent audit experiences as well as the handling of complex corporate actions. The IIAC has also prepared several member tools to assist with complex tax reporting issues.

OPERATIONAL SUPPORT

The IIAC, in collaboration with the Canadian Depository for Securities Ltd. ("CDS"), maintains the government legislated online tax reporting system used by issuers of publicly traded trusts, partnerships and exchange traded funds. This system serves as a central repository of tax information from issuers to the dealer community. Dealers are dependent on this online portal for the preparation of countless T3, T5 and T5013 slips for their clients. The IIAC annually leads work to update the portal to reflect any required modifications, for example, due to legislative changes to tax slips. The IIAC also communicates each year with the issuer community providing them the information they need to access the facility, answers to commonly asked questions and reminding them of the importance of uploading timely and accurate information. During tax reporting season the IIAC also provides a dedicated contact for issuers needing assistance with the facility.

CONCLUSION

IIAC members face growing tax processing and reporting requirements along side increased client expectations. The prospects of rising costs and heighted risk requires members to develop comprehensive plans for their tax reporting functions. Though visons will vary, all firms must strive for increased operational efficiencies while avoiding errors and penalties. Firms must understand and accept the limitations of their current capabilities when developing their plan forward. Success hinges on several factors including: the reliability and completeness of the firm's data, the adequacy of existing technology and knowledgeable staff that is capable to respond to new tax reporting requirements. If necessary, external service providers and advanced technologies should be brought in to assist with plan implementation.

It is time for tax reporting to come out of the shadows of dealer operations and be recognized as an integral part of the firm's value proposition to stakeholders. The IIAC will continue to shed light on important tax reporting matters and support the industry where required.