

Proposed Cost Basis Regulations on Debt Instruments and on Option Reporting

On the eve of Thanksgiving, the IRS released proposed regulations on cost basis reporting for debt instruments and the reporting of options. Under section 6045(g)(3) of the Internal Revenue Code, a note, bond, debenture, or other evidence of indebtedness acquired on or after January 1, 2013, is a security subject to the cost basis information reporting rules in section 6045(g)(1). Section 6045(h) provides rules for reporting certain information, including gross proceeds, with respect to the sale, exercise, lapse, or other closing transaction involving an option on a specified security granted or acquired on or after January 1, 2013. These proposed regulations supplement the existing regulations for reporting equities and mutual funds. The preamble to the proposed regulations makes clear that the general rules of Treas. Reg. §1.6045-1 which currently apply to stock also will apply to a debt instrument or an option that is a covered security, including the wash sale and short sale provisions. Transfer statements under section 6045A and issuer notices under section 6045B will also apply to fixed income and options.

The IRS and Treasury Department have requested comments within 90 days of inclusion of the proposed regulations in the Federal Register on the clarity of the proposed regulations and how they can be made easier to understand, and on suggested changes or improvements to all sections of §1.6045-1 that are not specifically affected by the proposed regulations. They have asked that written or electronic comments be received by February 23, 2012. A public hearing has been scheduled for Friday, March 16, 2012, beginning at 10 a.m. in the IRS Auditorium, 1111 Constitution Avenue, NW., Washington, DC. See NPRM REG-102988-11 at http://www.cokala.com/files/REG-102988-11_Basis_Reporting_Debt_Instruments_and_Options_11252011.pdf.

Options: A reportable covered option includes an option on one or more specified securities, including an index of these securities or on financial attributes of these securities, that is granted or acquired on or after January 1, 2013. For example, the proposed regulations would apply to an option on the S&P 500 Index.

One of the bigger issues the industry faced was whether the reporting would attach to compensation-based options such as non-qualified stock options provided to employees. The proposed regulations will exempt compensation-based options from these rules. Under the regulations, if a customer exercises a compensation related option, a broker is permitted, but not required, to adjust basis of the acquired stock for any amounts included as compensation income. The IRS intends to modify instructions to the Form 1040 (Schedule D) and other IRS forms and publications to remind a taxpayer that a reconciliation of basis may be required if the sale reported on a Form 1099-B is a sale of stock acquired through a stock grant or the exercise of a compensatory option. The IRS is exploring the possibility of adding an indicator on the

Form 1099-B to denote a sale of compensation-related stock. However, the proposed regulations under §1.6045A-1 modify the transfer statement inclusion list by now requiring information in the transfer statement about whether the security was acquired through an equity-based compensation arrangement.

The regulations define the cancellation, lapse, expiration, or other termination of an option as a reportable closing transaction, as well as a cash settlement being defined as a reportable transaction, following sections 1234 and 1234A. If an option is physically settled, that is exercised to acquire the asset or dispose of it, the premium paid or received will be used to adjust the basis of the purchased asset or adjust reported proceeds. A broker must increase gross proceeds for all payments received on the option and decrease gross proceeds for all payments paid on the option. The IRS points us to Publication 550, *Investment Income and Expenses*, for a detailed explanation of the appropriate tax treatment of the exercise or lapse of an option. If the option is disposed of without a physical settlement, a broker is required to report gross proceeds and whether the gain or loss is long-term or short-term.

The preamble to these proposed regulations says that if any option is sold prior to expiration, including an option acquired prior to January 1, 2013, the regulations currently in effect already require a broker to report the gross proceeds from that sale except in cases in which an option is closed by offset. We assume from this that the IRS is talking about the existing cost basis regulations but that they do not mean reporting options before January, 2013, but we find this to be an interesting comment on their part. The IRS also has addressed options and warrants acquired in restructurings or other issuer actions. If a customer receives a warrant or stock right in a section 305(a) distribution, a broker will be required to determine the basis of the warrant or stock right by following sections 305 and 307. These sections address taxable dividends in the context of many events including those involving a holder of rights, warrants or convertible securities where the term "stock" includes rights or warrants to acquire such stock, and the directions for apportioning basis in the context of a non-taxable distribution.

Option products also received attention. If more than one option is documented in a single contract, a broker must separately report the required information for each option as that option is sold. We read this to mean that where an option strategy such as a bear or bull call or put spread or collar involves more than one option, you report each option leg of the strategy, not the unit.

For an option, a transfer statement must include the date the option was granted or acquired, the amount of the premium, whether the premium was paid or received, and any other information required to describe the option, including a description of the relevant terms, or an identifier, such as a CUSIP or Options Clearing Corporation number or code.

The proposed regulations also amend §1.6045B-1 to provide rules for certain option writers if there is an organizational action. If the organizational action results in an option writer replacing the original option contract with a different number of option contracts, the option writer must prepare an issuer return as required by §1.6045B-1.

Debt instruments: Pursuant to section 6045(g), the proposed regulations amend §1.6045-1 to include a debt instrument in the definition of a specified security and a debt instrument acquired for cash in an account on or after January 1, 2013, in the definition of a covered security. Debt instruments are defined following Treas. Reg. §1.1275-1(d), covering any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan), as well as any other instrument defined as debt anywhere in the Internal Revenue Code. Similar to the rules for stock, if an issuer fails to classify the instrument, a broker is not required to treat the instrument as debt unless the broker knows that the security is reasonably classified

as debt under general Federal tax principles or that the instrument or position is treated as a debt instrument under a specific provision of the Internal Revenue Code.

Good news: Debt instruments with principal subject to acceleration under section 1272(a)(6) are exempted from the cost basis reporting rules. This section covers REMIC regular interests, instruments based on pooled debt and other collateralized debt obligations. In addition, no return of information is required from an issuer or its agent with respect to the retirement of book entry or registered form debt instruments issued before January 1, 2013, as to which the relevant books and records indicate that no interim transfers have occurred.

Bad news: If a debt instrument is acquired on or after January 1, 2013, a broker will be required to determine and account for original issue discount ("OID"), bond premium, acquisition premium, market discount, and principal payments to determine the adjusted basis of the debt instrument and whether any gain or loss upon the sale of the debt instrument is short-term or long-term, assuming that the customer has not made any elections with respect to the debt instrument. There are two exceptions: 1) a broker must assume that a customer has elected to use the constant interest rate method under section 1276(b)(2) to determine the amount of accrued market discount; and 2) a broker must assume that the customer has elected under section 171 to amortize bond premium on a taxable debt instrument. The broker will also be required to report the amount of any market discount that has accrued as of the date of a sale or transfer of a debt instrument. It is important to note that because the section 171 election assumption is inconsistent with the 1099-OID reporting rule under section 6049 providing that a payor is not permitted to take premium into account for purposes of reporting a holder's interest or OID income on Form 1099-INT or 1099-OID each year, brokers will not be able to just reduce basis by reportable OID.

The IRS has summarized these rules by saying:

- If a debt instrument is sold prior to maturity, a broker will report any accrued market discount as of the sale date based on a constant interest rate.
- Except as provided below, a broker must determine a customer's basis in a debt instrument by computing any OID, bond premium, or acquisition premium using the default method described in the relevant provisions of the Code or regulations. A broker also must adjust the basis for any principal payments received.
- If a taxable debt instrument has bond premium, a broker must assume a customer has elected current amortization when computing the amount of the customer's basis.
- If a debt instrument has both OID and market discount, the accrual period used for the OID computation must be used for the market discount computation.
- In all other situations, a broker must use the shorter of an annual accrual period or a period that matches the frequency of regular coupon or principal payments.

The devil is in the details and here are more details:

For accrued market discount, if a debt instrument is subject to the market discount rules in sections 1276-1278, the broker also must report the amount of market discount that has accrued on the debt instrument as of the date of the sale. If a debt instrument is subject both to the OID and the market discount rules, the broker must use the same accrual period that is used to determine the OID reported to the customer, to compute accruals of market discount. In any other situation, the broker must use an annual accrual period or, if there are scheduled payments of principal or interest at regular intervals of one year or less over the entire term, the broker must use an accrual period equal to the interval.

For original issue discount, if a debt instrument is subject to the OID rules, the broker must increase the customer's basis in the debt instrument by the amount of OID reported to the customer for each year the debt instrument is held by the customer in the account. If the debt

instrument is not subject to section 6049 OID reporting rules, or is a tax-exempt debt instrument subject to section 1288, the broker must increase the customer's basis by the amount of OID that accrued on the debt instrument while held by the customer in the account.

For bond premium, the broker must decrease the customer's basis in the debt instrument by the amount of bond premium allocable to the period the debt instrument is held by the customer in the account.

For acquisition premium, the broker must decrease the customer's basis by the amount of acquisition premium taken into account each year to reduce the amount of OID otherwise includable in the customer's income for that year.

For principal and other payments, the broker must decrease the customer's basis by the amount of any payment made to the customer during the period the debt instrument is held in the account (other than a payment of qualified stated interest).

The rules for transfer statement inclusions have added the following details to cover debt instruments:

- A description of the payment terms;
- The issue price of the debt instrument;
- The issue date of the debt instrument;
- The adjusted issue price of the debt instrument as of the transfer date;
- The customer's initial basis in the debt instrument;
- The yield used to compute any accruals of original issue discount, bond premium, and/or market discount;
- Any market discount that has accrued as of the transfer date; and
- Any bond premium that has been amortized as of the transfer date.

Changes that affect all 1099-B reports:

- Today, a broker may choose to report gross proceeds from the sale of a security as the entire proceeds from the sale or as the proceeds reduced by the commissions and transfer taxes related to the sale. Under the proposed regulations, for sales beginning in 2013, the adjustments become mandatory.
- The broker may, but is not required to, take into account option premiums and/or income recognized on the exercise of a compensatory option or vesting or exercise of other equity-based compensation arrangements before January 1, 2013.
- Today, a broker must adjust basis reported for an organizational action taken by an issuer of a security during the period the broker has custody of the security. For a transferred security, the regulations exclude adjustments for organizational actions taken on the transfer settlement date. The proposed regulations clarify that the exclusion applies only to the broker receiving custody of a transferred security and require that a broker transferring a security reflect all necessary adjustments for organizational actions taken through and on the transfer settlement date when completing a transfer statement.
- Short sale obligation transferred to another account: If a short sale is satisfied by delivery of a security transferred into a customer's account accompanied by a transfer statement indicating the security was borrowed, the receiving broker does not file an information return, but must furnish a statement *to the transferor* that reports the gross proceeds received from the short sale, date of sale, quantity of shares or units or amounts sold, and CUSIP (or other identifier number that has been authorized for use).
- Sales between interest payment dates: For each sale of a debt instrument prior to maturity with respect to which the broker must file a Form 1099-B, the broker must show separately the amount of accrued and unpaid interest as of the sale date that must be

reported by the customer as interest income (but not the amount of any market discount on a noncovered security or OID). This is also under current rules reportable on Form 1099-INT or OID as applicable.

- Gross proceeds defined: Gross proceeds on a sale are the total amount paid to the customer or credited to the customer's account as a result of the sale, reduced by the amount of any stated interest, and increased by any amount not paid or credit by reason of repayment of margin loans. In the case of a closing transaction that results in a loss, gross proceeds are the amount debited from the customer's account. Please see the proposed reg for additional details.

General changes in the transfer statement rules:

The proposed regulations make an additional requirement for transfer statements for all covered securities to report whether the security was received in connection with the exercise of a compensatory option or the vesting or exercise of any other equity-based compensation arrangement, and whether basis has been adjusted for any compensation income.

For transfer statements in general, if the customer does not provide an adequate and timely identification for the transfer, a transferor must first report the transfer of any securities in the account for which the transferor does not know the acquisition or purchase date, followed by the earliest securities purchased or acquired whether those are covered securities or noncovered securities.

If the transferor and the receiving broker agree, codes or combination or information may be used on the transfer statement. Example: a single code may represent the broker name, address and phone number; a security symbol or other identification number or scheme may be used as the security identifier.

The general transfer statement information is not required for a transfer of a noncovered security if the transfer statement identifies the security as a noncovered security; a transferor must treat as a covered security, a security for which a broker makes a single-account election.