Final Cost Basis Regulations Released on Debt Instruments and Option Reporting; Temporary Regulations Change Interest and OID Reporting

On April 17, 2013, the IRS released final regulations on cost basis reporting for debt instruments and the reporting of options that are for the most part effective for 2014 consistent with promises made in Notice 2012-34, 2012-21 IRB 937. However, for more sophisticated securities listed in the regulations and for transfer statements, a phase-in was established over the subsequent one to two years. At the same time as the cost basis regulations were released, temporary regulations were released that change the methods for calculating reportable interest and original issue discount (OID) to integrate interest reporting with the basis adjustment requirements for covered debt obligations, starting in 2014. A very limited set of securities were exempted from the basis reporting requirements altogether.

I. Some key changes to note effective 2014.

A. General 1099-B changes.

- **Ordinary income classification added.** For a sale of a covered security on or after January 1, 2014, brokers will need to classify gain or loss as ordinary income in addition to short-term or long-term capital gain. [Reg. §1.6045-1(d)(2)]

- **Adjustments for commissions and transfer taxes are mandatory for sales on or after January 1, 2014.** 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. Beginning in 2014, the adjustments are mandatory. [Reg. §1.6045-1(d)(5)]

- **U.S. dollar value of foreign currency gross proceeds determined using spot rate on date received.** When a payment other than a payment of interest is made in a foreign currency, a broker must determine the U.S. dollar amount of the payment by converting the foreign currency into U.S. dollars on the date it receives, credits, or makes the payment, as
applicable, at the spot rate (as defined in Reg. § 1.988-1(d)(1)) or pursuant to a reasonable spot rate convention.

**B. Debt-related Summary.**

For details see the larger section on debt below.

- **What is debt?** The terms debt instrument, bond, debt obligation, and obligation mean a debt instrument as defined in Reg. §1.1275-1(d) to be 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), and any instrument or position that is treated as a debt instrument under a specific provision of the Internal Revenue Code (for example, a regular interest in a REMIC as defined in §860G(a)(1) and Reg. §1.860G-1). [Reg. §1.6045-1(a)17]

- **Debt presumption.** For purposes of 1099-B reporting, a security classified as debt by the issuer is treated as debt. But if the issuer has not classified the security, the security will not be treated 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. These rules are similar to the rules for stock.

- **Simple debt** becomes covered for basis reporting if acquired in 2014.

- **More complex debt** is phased-in for coverage when acquired in 2016. See the list in section below on covered debt.

- **Short-term debt** issued in 2014 and later is no longer subject to 1099-B reporting and will be exempt from basis reporting and adjustments.

- **Debt subject to principal acceleration**, for example a regular REMIC interest or other collateralized bond, and pools of debt instruments the yield on which may be affected by prepayments are exempt from cost basis reporting, but remain subject to gross proceeds reporting on the 1099-B.

- **New 1099-INT and OID reporting.** Temporary regulations were included to require broker reporting of amounts of stated interest and OID income on Forms 1099-INT and 1099-OID to be adjusted by amortized bond premium or acquisition premium for a covered debt instrument acquired on or after January 1, 2014.

- **Must use same accrual periods for income and basis reporting.** In addition, for both basis adjustments and Forms 1099-INT and OID reporting, brokers must use the same accrual periods, and in other matters are to default to a semi-annual accrual period. The IRS chose not to set day-count or rounding protocols.

- **Bond premiums and acquisition premiums.** New reporting rules will require brokers to report information using default assumptions following statutory and regulatory
requirements; but, will require brokers to accommodate all customer elections, including those in effect on securities transferred to the broker.

- **The taxable bond premium election** under §171 is an exception to this rule. Forms 1099-INT and 1099-OID, as well as basis adjustments are to be reported assuming a §171 bond premium election. Customers can elect otherwise and brokers will need to follow customer’s election notice.

- **Assumption for acquisition premiums**: brokers are to assume the customer has not elected to amortize acquisition premium based on a constant yield. Customers can elect otherwise and brokers will need to follow customer’s election notice.

- Apart from the debt elections outlined further below under the section entitled Required Basis Adjustments, a broker is not required to consider customer elections.

- **Puts and calls.** When assessing the effect of an embedded put or call option on a debt instrument, a broker must apply the rules described in §1.1272-1(c)(5) or §1.171-3(c)(4), whichever is applicable, to determine the correct date to be used in accrual calculations. The IRS believes the presumptions under these provisions will make the accruals uniform and are easy to apply so they declined to exempt these securities.

- **Accrued market discount** is to be reported on the Form 1099-B associated with a specific sale of a covered single security acquired on or after 2014. Market discount is accrued as of the date of the instrument’s sale and is to be calculated on a straight line basis unless the customer elects and notifies the broker to accrue market discount using a constant yield. Upon notice of election, the broker must report according to the election. The rules for reporting accrued stated interest on a Form 1099-INT when a debt instrument is sold between interest payment dates will not apply to accrued market discount.

  If the customer elects and notifies the broker to include market discount in income currently, it is not reported at point of sale. Instead, the broker is required to report to the customer the amount of market discount that accrued on a debt instrument during a taxable year while held by the customer in the account. The broker also must adjust basis in accordance with this election.

- **Calculations are required only once a year** unless there is a transfer.

- **Partial principal paydowns** are reportable sales and the amounts paid are gross proceeds subject to 1099-B reporting. Since paydowns are now considered a sale, accrued market discount is to be reported on the related Form 1099-B. Managing accruals in this context may prove challenging.

- **Transfer agents** lose the book-entry exemption from 1099-B reporting for debt issued in 2014 and later.

- **Demand obligations issued in 2014** and later that are callable by the obligor and that have no premium or discount will become subject to 1099-B reporting in 2014.
C. Option-related Summary.

For details see the larger section on options below.

- **Scope.** On options, the scope of the final regulations is generally the same as the scope of the proposed regulations, except that final regulations explicitly:

  - Excluded a compensatory option from 1099-B reporting and as covered options subject to basis reporting.

  - Added §1234B securities futures contracts, including single stock futures to the definitions of specified security and covered security.

- **No compensation elements** from equity-based compensation arrangements, granted or acquired on or after January 1, 2014, may be used even on an optional basis to adjust the basis in the stock acquired through the plan.

- **No straddle accountability.** Brokers are not required to apply straddle rules under §1092, even as to qualified covered calls, when reporting adjusted basis.

- **Must be on a specified security.** An option is subject to 1099-B reporting under §6045 only if the option references one or more specified securities outlined in the option section below.

- **Nonequity options are reported under regulated futures rules.** To be reportable, a non-equity option described in §1256(b)(1)(C) must be on one or more specified securities; but, the broker must treat the option as if it were a regulated futures contract subject to reporting under the mark-to-market rules described in Reg. §1.6045-1(c)(5). These options were made exempt from transfer statement reporting.

  A broker is permitted, but not required, to report the amounts for options and the amounts for regulated futures contracts as a net amount for each reportable item. [Reg. §1.6045-1(m)(3)]

- **Penalty relief if make a mistake as to a narrow or broad option.** Penalty relief has been provided in distinguishing broad-based non-equity options from narrow based options subject to the general option reporting rules.

- **No special relief for OTC options.** See the transfer statement section below for special requirements.

- **Rights and warrants.** When a right or warrant to acquire stock is received in the same account as the underlying security in a distribution that is described in §305(a), a broker is permitted, but not required, to apply the rules described in §305 and §307 when reporting or accounting for the basis of the option and the underlying equity. See the discussion below on what this mea
• IRS gave no relief from wash sales or short sale applications to reportable §1256 options, apart from the restriction that the events must occur in the same account and for wash sales involve the same security (CUSIP) number.

D. Transfer statements

• Deferred effective dates. Transfer reporting for debt instruments, options, and securities futures contracts otherwise covered beginning in 2014 will not be required until 2015. Transfer reporting for more complex debt instruments otherwise covered in 2016 will not be required until January 1, 2017. [Reg. §1.6045A-1(d)]

• Debt and Options are provided for. The transferor must determine adjusted basis information as provided under Reg. §§1.6045-1(d), 1.6045-1(m), and 1.6045-1(n), including reporting the adjusted basis of the security in U.S. dollars.

• Debt. The rules for transfer statements have changed to cover debt instruments:

  Require additional transfer statement information to advise a receiving broker of any elections that were used to compute the information provided.

  Require a broker to compute debt instrument accruals no more than once per year unless a transfer takes place during a tax year, in which case the transferring broker must compute to provide a correct transfer statement to the receiving broker.

  If providing a CUSIP number or similar security identifier is adequate to enable the receiving broker to obtain some of the required information, a transferring broker is permitted to supply the CUSIP number or security identifier as a substitute for that information. For example, data that applies to all debt instruments in an issue, such as issuer name, issue date, coupon rate, coupon payment dates, or issue price, might be data that could be derived from a CUSIP or other security identifier. If so, all that is needed is the CUSIP. However, a receiving broker may request to receive from the transferor broker the detailed information specified in the regulations.

  Further, data specific to a customer, such as price paid by the customer, the acquisition date, or yield, and any elections must be transmitted separately as this data will be different for each customer and cannot be derived from the CUSIP number.

  The amount of acquisition premium already amortized, as well as the accrued market discount and amortized bond premium, and the date through which the transferor broker made adjustments, have been added to the list of items to be provided.

  Other items to be provided include:

  ▪ 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.

- 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 final 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.

- 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.

- **OTC options.** The final regulations under §6045A require the transferor of an OTC option to provide detailed information to a receiving broker sufficient to describe the option. This could include data about the underlying asset, contract size, non-standardized strike price, and expiration date.

- **§1256 options exempted from transfer statements.** A transferor of an option described in §1.6045-1(m)(3) is not required to furnish a transfer statement. [Reg. §1.6045B-1(a)(1)(vi)]

- **No request for the missing transfer statement is required to treat options, securities futures contracts, and debt as noncovered.** If a covered option, a securities futures contract, or a debt instrument is transferred and no transfer statement is received, unlike for covered stock, the receiving broker is not required to request a transfer statement from the transferor and may treat the security as a noncovered security.

### E. Issuer action statements

- A broker is not required to consider transactions or events occurring outside the account except for an organizational action taken by an issuer during the period the broker holds custody of the security (beginning with the date that the broker receives a transferred security) reported on an issuer statement furnished or deemed furnished to the broker. [Reg. §1.6045-1(d)(6)]

- **Issuer action statements (Forms 8937)** that affect the basis of simple debt instruments, options, and securities futures contracts apply to issuer actions occurring on or after January 1, 2014.
• **Issuer action statements that affect the basis of more complex debt instruments** otherwise covered in 2016 will apply to issuer actions occurring on or after January 1, 2016. [Reg. §1.6045B-1(j)]

• **REMIC regular interests and other debt where the principal may be accelerated are not a specified securities** so are not subject to issuer action reporting under §6045B.

• **Form 8937 may be posted** with an electronic signature (instead of written signature).

• **Reorganizations, such as mergers and acquisitions**, are among the organizational actions that can trigger reporting under §6045B. The Preamble gives the following example: the issuance of a debt instrument in a recapitalization, including a recapitalization resulting from a significant modification or a bankruptcy reorganization, can be an issuer action affecting the basis of a debt instrument requiring an issuer action statement.

• **Change needs to result in a different number of option contracts to be a reportable action.** An option issuer only needs to comply with Reg. §1.6045B-1 if the change in the underlying asset results in a different number of option contracts. If the terms of the option are changed to reflect a corporate event, but the number of option contracts does not change, a §6045B event has not occurred.

• **A clearing organization that is the counterparty to an exchange-traded option** is the issuer of the option for purposes of §6045B.

• **The writer of an OTC option** is the issuer for purposes of §6045B.

• **Rules for exchange traded options.** For purposes of issuer action notices, if the original option contract is replaced by a different number of option contracts, and the option is an exchange-traded option, any clearinghouse or clearing facility that serves as a counterparty will be treated as the issuer of the option and will be required to comply with the issuer action notice requirements.

• **OTC option rules.** If the option is not an exchange-traded option, the option writer will be treated as the issuer of the option for purposes of complying with the issuer action notice requirements. 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.

II. Details on Debt Changes

• **Starting in 2014 partial principal paydowns are 1099-B reportable.** Reportable transactions on 1099-B will include a partial retirement attributable to a principal payment received on or after January 1, 2014. [Reg. §1.6045-1(a)(9)] Most report these payments now on Form 1099-B, but after 2014 all questions on reportability should be resolved.

• **Accrued market discount is to be reported on 1099-B.** In the case of a sale, accrued market discount is to be reported on the Form 1099-B and to accommodate, each single security
will need to be reported separately with its specific accrued market discount. The rules for reporting accrued stated interest on a Form 1099-INT when a debt instrument is sold between interest payment dates will not apply to accrued market discount. A broker must report the amount of market discount that has accrued on a debt instrument as of the date of the instrument’s sale. This reporting, however, does not apply if the customer notifies the broker that customer elects under §1278(b) to include market discount in income as it accrues. Where the election is in place, the broker is required to report to the customer the amount of market discount that accrued on a debt instrument during a taxable year while held by the customer in the account. The broker also must adjust basis in accordance with §1278(b)(4). See more on allowed elections in basis adjustment section below. [Reg. §1.6045-1(d)(3); §1.6045-1(n)(6), (8)]

- **For debt instruments, reportable gross proceeds** is 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 qualified stated interest accrued between payment dates reported on Form 1099-INT.

- **Form 1099-B reporting exemption granted for all short-term debt issued on or after January 1, 2014.** Final regulations exempt from 1099-B gross proceeds reporting all short-term debt instruments issued on or after January 1, 2014 with fixed maturity dates not more than one year from the date of issue, including Treasury bills, state and local government short-term paper and bills, and private sector commercial paper. Under the new rules, no return of information is required with respect to a sale (including a retirement) of a short-term obligation issued on or after January 1, 2014. [Reg. §1.6045-1(c)(3)(xiii)] The term of the debt instrument includes either the issue date or the maturity date, but not both dates, in determining the maturity period for the short-term classification. The maturity date of a debt instrument is the last possible date that the instrument could be outstanding under the terms of the instrument that is not a remote or incidental contingency.

  For 2013, brokers will report following the rules currently in effect, so reporting will be required for short-term debt with OID that is actually sold prior to maturity (retirement). The current short-term reporting exemption is only upon debt retirement. [Reg. §1.6045-1(c)(3)(vii)(C)]

- **Demand obligations issued on or after January 1, 2014, are 1099-B reportable starting in 2014.** Currently, demand obligations that are callable by the obligor and that have no premium or discount are exempt from 1099-B reporting. Starting in 2014, such instruments issued on or after January 1, 2014, will be subject to both 1099-B reporting and the basis reporting requirements. Many municipalities issue such obligations and brokers will need to change their treatment to meet these new reporting and basis tracking demands. [Reg. §1.6045-1(c)(3)(vii)(D)]

- **Transfer agents lose book-entry 1099-B exemption in 2014 and will be required to 1099-B report debt dispositions.** Currently, no return of information is required from an issuer or its agent with respect to the retirement of book entry or registered form obligations as to
which the relevant books and records indicate that no interim transfers have occurred. For debt instruments issued on or after January 1, 2014, transfer agents and issuers will need to begin reporting sales, retirements, and partial paydowns of principal on Form 1099-B and to include cost basis information. No return of information, however, 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, 2014, as to which the relevant books and records indicate that no interim transfers have occurred.

**POINTER: Accounts payable and treasury facilities** will also need to consider 1099-B reporting under these new provisions on their private debt holders. For these purposes, a “broker” is defined broadly to include any person who for consideration regularly acts as a middleman regarding property or services. Brokers also include companies that regularly redeem their own stock or retire their own debt.

**A. Covered debt instruments:**

- **Basis reporting is not required for short-term debt and for REMIC regular interests and other debt with principal subject to acceleration.**

  All short-term debt obligations, including Treasury bills, state and local government instruments, private sector commercial paper, and all debt with fixed maturity dates not more than one year from the date of issue will not be considered covered securities and will be exempt from basis reporting; and

  Debt instruments with principal subject to acceleration, including REMIC regular interests and other collateral-backed securities, and pools of debt instruments the yield on which may be affected by prepayments (IRC §1272(a)(6) securities) will not be considered covered securities and will be exempt from basis reporting.

  [Reg. §1.6045-1(a)(14)(ii); Reg. §1.6045-1(n)]

  **POINTER:** Short-term for these purposes is defined in IRC §1272(a)(2)(C) as with a fixed maturity date not more than 1 year from the date of issue. See the discussion above on the reporting exemption. Both the basis and the reporting exemptions will NOT include debt instruments originally issued with a term of greater than one year when acquired in the secondary market with a remaining term of one year or less. Care will need to be taken to assure that the security master file carries original issue dates for all debt instruments to support proper tax reporting.

- **Phased in effective dates for other debt instruments:**

  **Debt issued in a bankruptcy restructuring is covered and subject to basis reporting.**

  The IRS declined to exempt debt issued in a bankruptcy restructuring because they believed the debt presumption rules discussed above resolved confusion.

  **Simple debt covered in 2014:** Reporting of basis and the long-term or short-term character of the gain or loss will be required for debt instruments acquired on or after
January 1, 2014 when the debt will become considered a covered security. Covered debt for 2014 will include:

- **Instruments with a single fixed payment schedule.** Taxable private sector, tax–exempt (state and municipal), and U.S. Treasury debt with a single fixed payment schedule for which a yield and maturity can be determined. If with OID, the calculation would require the more basic constant yield calculation outlined under Reg. §1.1272-1(b).

- **Debt that provides for an alternate payment schedule, but where a yield and maturity can nonetheless be determined.** For debt in this category, the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and one payment schedule is significantly more likely than not to occur so is to be used to calculate yield. These instruments usually have OID and are subject to Reg. §1.1272-1(c). Instruments with mandatory sinking funds and debt with embedded put or call options are included in this category where the regulations provide assumptions for accruals and for handling subsequent adjustments where needed. When assessing the effect of an embedded put or call option on a debt instrument, a broker will be required to apply these assumptions as described in §1.1272-1(c)(5) or §1.171-3(c)(4).

- **Demand loans** (now reportable, see above) and other debt for which a yield can be determined under Reg. §1.1272-1(d). This category applies if a debt instrument provides for one or more contingent payments, but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield and the debt considered covered in 2014. For example, the yield of a debt instrument with principal payments that are fixed in total amount, but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument.

  [$1.6045-1(a)(15)(i)(C); §1.6045-1(n)(2)]

  **POINTER:** The IRS indicated that it believes that only the less complex debt will become covered in 2014, thinking that all the complex debt is either in the express list of deferred instruments or related to short-term debt or accelerated principal debt totally exempted from these provisions.

**More complex debt covered in 2016:** For the following debt instruments, the regulations do not cover the securities until acquired on or after January 1, 2016.

- **Variable rate debt,** inflation-indexed debt instruments, stepped bonds and other debt with more than one rate of stated interest. A debt instrument does not provide for more than one rate of stated interest merely because the instrument provides

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for a penalty interest rate or an adjustment to the stated interest rate in the event of a default or similar event.

- **Convertible debt instruments**, including debt with options or warrants. [Debt falling under Reg. §1.1272-1(e).] A convertible bond is defined in Reg. §1.171-1(e) as a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. For bonds issued on or after February 5, 2013, the term stock in the preceding sentence includes an equity interest in any entity that is classified, for Federal tax purposes, as a partnership. [Reg. §1.1272 as amended by T.D. 9612, 2/4/2013]

If a customer acquires a convertible bond at a premium determined under §1.171-1(d), then, solely for purposes of §1.6045-1 (reporting on Form 1099-B) and Reg. §1.6049-9T (reporting on Form 1099-INT or Form 1099-OID), a broker must assume that the premium is attributable to the conversion feature. Based on this assumption, no portion of the premium is amortizable for purposes of these sections. [Reg. §1.6045-1(n)(9)] See more information below.

- **A stripped bond or stripped coupon** under IRC §1286.

- **Non-dollar denominated debt** instruments (requires payment of either interest or principal in a currency other than the U.S. dollar).

- **Tax credit bonds**: debt instruments that, at one or more times in the future, entitle a holder to a tax credit. This category includes Build America Bonds, qualified forestry conservation bonds, new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, qualified school construction bonds, clean renewable energy bonds, Midwestern tax credit bonds, and all other qualified tax credit bonds, including all issuances of specified tax credit bonds, but only where the issuer has made the election to offer tax credits.

- **PIK (payment-in-kind) bonds** where under the terms of the debt instrument, the holder may receive one or more additional debt instruments of the issuer in lieu of an interest payment.

- **Foreign debt** issued by a non-U.S. issuer.

- **Terms unavailable**. A debt instrument for which the terms of the instrument are not reasonably available to the broker within 90 days of the date the debt instrument was acquired by the customer.

- **Derivatives with debt inclusions**. A debt instrument that is issued as part of an investment unit described in §1.1273-2(h) where the unit is treated as if it were a debt instrument for OID calculation purposes. This category will include most derivatives with debt inclusions.
Note: If an option, stock right, or warrant is issued as part of an investment unit described in §1.1273-2(h), the option, stock right, or warrant if it is acquired on or after January 1, 2016, will be separately subject to option reporting requirements outlined below.

- **A debt instrument evidenced by a physical certificate, but not if held through a bank or broker or custodian or other nominee.** A debt instrument evidenced by a physical certificate unless held by a securities depository or by a clearing organization is deferred to 2016. The term clearing organization means an entity that is in the business of holding securities for its member organizations or clearing trades of securities and transferring, or instructing the transfer of, securities by credit or debit to the account of a member without the necessity of physical delivery of the securities. [Reg. § 1.1471-1(b)(18)] Debt will be considered held through a securities depository or clearing organization even if held through a nominee (broker or bank), agent, or subsidiary.

  §1.6045-1(a)(15)(i)(D); § 1.6045-1(n)(3)]

**B. Required basis adjustments for debt instruments:**

- **Brokers are not required to track straddles** under §1092 when reporting adjusted basis. [Reg. §1.6045-1(d)(6)(iv)] This provision was added to exceptions already in place for §1259 (regarding constructive sales), §475 (regarding the mark-to-market method of accounting), and §1296 (regarding the mark-to-market method of accounting for marketable stock in a passive foreign investment company).

- **Accrual periods:** a broker must use the same accrual period used to report OID or stated interest under §6049. In any other situation, a broker is required to use a semi-annual accrual period and may not use an annual accrual period as the default period. If the debt instrument provides for scheduled payments of principal or interest at regular intervals of less than six months over its term, a broker must use an accrual period equal in length to the shorter interval. [Reg. §1.6045-1(n)(8)]

- **Calculations are required only once a year** unless there is a transfer.

- **Day-count convention:** Final regulations provide that a broker may use any reasonable day count convention period for determining the length of the accrual periods: for example, 30 days per month/360 days per year, actual days per month/360 days per year, or actual days per month/365 days per year. But if the terms of a debt instrument include a day count convention that the issuer will use to compute interest payments, brokers must follow it. The final regulations also do not prescribe a particular rounding convention. [Reg. §1.6045-1(n)(8)]

- **OID adjustments:** If a debt instrument is subject to the OID rules in §§1271-1275 or §§ 1286 - 1288, a broker must increase a customer’s basis in the debt instrument by the amount of OID that accrued on the debt instrument while held by the customer in the account.
• Other required basis adjustments are subject to the default presumptions and elect overrides outlined in the next section. A broker is not required to consider customer elections except those assumptions and elections outlined below. [Reg. §1.6045-1(d)(6); Reg. §1.6045-1(n)(6),(7)]

• The following basis adjustments and assumptions are required:

  **Taxable bond premiums** unless customer informs the broker that the customer does not want to amortize bond premiums under IRC §171, assume the election has been made. See below for more on elections that affect bond premiums.

  **Tax-exempt bonds.** A broker is required to adjust the customer’s basis for any tax-exempt obligation acquired at a premium.

  **Acquisition premium.** If a debt instrument is acquired at an acquisition premium, a broker must decrease the customer’s basis in the debt instrument by the amount of acquisition premium that is taken into account each year to reduce the amount of OID that is otherwise includible in the customer’s income for that year. However, if a customer informs a broker that the customer elects to use a constant yield to amortize the acquisition premium (see below), then the broker must decrease the customer’s basis in the debt instrument by the amount of acquisition premium that is taken into account each year to reduce the amount of OID that is otherwise includible in the customer’s income for that year in accordance with §1.1272-2(b)(5) and §1.1272-3.

  **Market discount.** See below for rules on elections that affect the adjusted basis of a debt instrument with market discount. In the case of a sale, accrued market discount is to be reported on the Form 1099-B and to accommodate, each single security will need to be reported separately with its specific accrued market discount.

  **Principal and certain other payments.** A broker must decrease the customer’s basis in a debt instrument 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 as defined in §1.1273-1(c).

• **New reporting rules will require brokers to report information using default assumptions; but, will require brokers to accommodate all customer elections, including those in effect on securities transferred to the broker.** The taxable bond premium election under §171 is an exception to this rule. The assumptions and elections discussed below only apply for purposes of a broker’s reporting obligation under §6045 on Form 1099-B. A customer is not bound by these assumptions and may take different positions in customer’s tax returns. In addition, customers’ notifications of the following elections are not considered to be substantively effective. Customers will still need to comply with their tax return requirements in making these elections. [Reg. §1.6045-1(n)(4),(5)]
Upon written notification, including a writing in electronic format by a customer, a broker must take into account the following elections for basis reporting purposes, but is to assume no election has been made without prior notice:

- **The election to include market discount in income currently** as it accrues under §1278(b). The election applies to all debt instruments acquired by a taxpayer during the taxable year the election is effective and thereafter and may be revoked only with IRS permission. If the customer makes this election, the broker also must adjust basis in accordance with §1278(b)(4).

- **The election to accrue market discount based on constant yield** under §1276(b)(2), made on an instrument-by-instrument basis for the earliest taxable year for which the taxpayer is required to determine accrued market discount on the debt instrument. Once made, the election may not be revoked.

- **The election to treat all taxable interest as OID (adjusted by premiums)** under Reg. §1.1272-3, made on an instrument-by-instrument basis for the taxable year the debt instrument is acquired and may be revoked only with IRS consent.

- **The spot rate election for interest accruals with respect to a covered debt instrument denominated in a currency other than the U.S. dollar** under Reg. §1.988-2(b)(2)(iii)(B). The election applies to interest income and expense at the spot rate on the last day of the accrual period or, in the case of a partial accrual period, the last day of the taxable year; and applies to all taxable debt instruments held by a taxpayer during the taxable year the election is effective and thereafter and may be revoked only with IRS consent.

For these elections, a customer must notify the broker in writing, including a writing in electronic format by a customer, by the end of the calendar year in which a debt instrument subject to the election is acquired in, or transferred into, an account with the broker or, if later, by the end of the calendar year for which the election is effective.

For revocation of an election for a calendar year, the customer must notify the broker of the revocation in writing, including a writing in electronic format by a customer, by the end of the calendar year for which the revocation is effective. If the customer provides such notification, the broker must report the information by taking into account the revocation.

**Section 171 election to amortize bond premiums on taxable debt.** A broker must assume that the customer has elected under section 171 to amortize bond premium on a taxable debt instrument. These final regulations make an exception to the general rule requiring brokers to use the default elections provided in the statute and regulations in the case of bond premium. Section 171 generally requires taxpayers to affirmatively elect to amortize bond premium on taxable bonds, which then offsets interest income on the bond. However, for these purposes, the broker is to assume the election has been made. The IRS points out in the Preamble that except in the rare case of a holder...
that prefers a capital loss, the election to amortize bond premium generally will benefit the holder of a debt instrument. Note that for tax-exempt debt, bond premiums are required to adjust basis.

- If a customer notifies a broker in writing, including a writing in electronic format, that customer does not want the broker to take into account the election to amortize bond premium, the broker must report the information without taking into account the election to amortize bond premium. The customer must provide this notification to the broker by the end of the calendar year for which the customer does not want to amortize bond premium.

- If for a subsequent calendar year, the customer wants the broker to take into account the election to amortize bond premium, the customer must notify the broker in writing, including a writing in electronic format, by the end of the calendar year that the customer wants to amortize bond premium. If the customer provides such notification, the broker must report the information as if the customer made the election to amortize bond premium for that year.

III. OID and interest calculations for 1099-INT and 1099-OID reporting

- **Starting 2014, private debt if SEC registered will need to file Form 8281.** Information Return for Publicly Offered Original Issue Discount Instruments. Form 8281 is used as a source to list securities in Publication 1212. Brokers can rely on Pub. 1212 as a safe harbor for identifying securities with reportable OID unless they are the issuer or part of the underwriting group. This will expand the reportable OID security base.

  Form 8281 will now apply to a debt instrument that is part of an issue the offering of which is registered with the Securities and Exchange Commission after the issue date of the debt instrument, for securities issued on or after January 1, 2014, even if otherwise considered a private offering. [Reg. §1.1275-3(c)] Form 8281 is due within 30 days of the date the offering is registered with the Securities and Exchange Commission.

- **New §6049 regulations for adjusting bond premiums and acquisition premiums effective for reportable interest on securities acquired on or after January 1, 2014.** The temporary regulations under §6049 relating to the handling of premiums apply to securities acquired on or after January 1, 2014.

- **Bond premiums.** A broker must assume that the customer has elected under section 171 to amortize bond premium on a taxable debt instrument. For reporting purposes, a customer can notify a broker that the customer has not made or has revoked a §171 election (see above), and the broker is required to reflect this fact on the Form 1099-INT and the Form 1099-B.

  If a broker is required to report amounts reflecting amortization of bond premium, the temporary regulations allow a broker to report either a gross amount for both stated interest and amortized bond premium or a net amount of stated interest that reflects
the offset of the stated interest payment by the amount of amortized bond premium allocable to the payment.

- **Acquisition premiums.** A broker must report OID adjusted for acquisition premium in accordance with Reg. §1.1272-2 by assuming that a customer has not elected to amortize acquisition premium based on a constant yield. If the broker has been notified that the customer has made an election to amortize acquisition premium based on a constant yield (see above), the broker is required to reflect this fact on the Form 1099-OID and the Form 1099-B.

  The temporary regulations allow a broker to report either a gross amount for both OID and acquisition premium, or a net amount of OID that reflects the offset of the OID by the amount of amortized acquisition premium allocable to the OID.

### IV. Details on Covered Options

- The scope of the final regulations are generally the same as the scope of the proposed regulations, except that the final regulations explicitly exclude a compensatory option, and added §1234B single stock futures and securities futures contracts to the definitions of specified security and covered security.

- **In the context of an option, a reportable sale does not include:** entering into a contract that requires delivery of personal property or an interest therein, the initial grant or purchase of an option, or the exercise of a purchased call option for physical delivery except for a foreign currency contract described in §988(c)(5).

  When a closing transaction for a contract described in §988(c)(5) involves making delivery, there are two sales, one resulting in profit or loss on the contract, and a separate sale on the delivery. In these contracts, a broker may assume that any customer’s functional currency is the U.S. dollar. Section 988(c)(5) considers contracts where the taxpayer takes or makes delivery in connection with entering into or acquiring any forward contract, futures contract, option, or similar financial instrument. In these situations, any gain or loss (determined as if the taxpayer sold the contract, option, or instrument on the date on which taxpayer took or made delivery for its fair market value on such date) is to be recognized in the same manner as if such contract, option, or instrument were sold.

- **For these purposes, a closing transaction** is a lapse, expiration, settlement, abandonment, or other termination of a position. A position includes a right or an obligation under a forward contract, a regulated futures contract, a securities futures contract, or an option.

- **Brokers are not required to track straddles** under §1092 when reporting adjusted basis. [Reg. §1.6045-1(d)(6)(iv)] Consistent with the approach taken for basis reporting for stock, final regulations explicitly provide that a broker will not take §1092 into consideration when determining basis of an option that is a covered security, including the qualified covered call rules in §1092(c)(4).
A. Covered options

- **Compensatory options are exempt** from the reporting requirements. [Reg. §1.6045-1(m)(2)(iii)]

  **No indicator on 1099-B for sold shares from compensatory plans.** The Treasury Department and the IRS also agreed that a compensation-related field should not be added to the Form 1099-B. Reported basis will be the strike purchase price from the compensatory option modified by issuer action notices and, if applicable, wash sale adjustments.

  Final regulations provide that brokers are not permitted to adjust basis to account for the exercise of a compensatory option that is granted or acquired on or after January 1, 2014. Prior to 2014, brokers at their option could make the basis adjustments for the compensatory component.

- **Basis reporting applies to the following types of options granted or acquired on or after January 1, 2014:**
  
  An option on one or more specified securities (which includes an index substantially all the components of which are specified securities);

  An option on financial attributes of specified securities, such as interest rates or dividend yields; or

  A warrant or a stock right.

- **Specified securities include:**
  
  Any share of stock (or any interest treated as stock, including, for example, an American Depositary Receipt) in an entity organized as, or treated for Federal tax purposes as, a corporation, either foreign or domestic.

  Any debt instrument, other than an exempted debt instrument where the principal is subject to acceleration such as a REMIC or a short-term.

  Any option on a covered option or other specified security; including an index substantially all the components of which are specified securities; any option on financial attributes of specified securities, such as interest rates or dividend yields; or

  Any securities futures contract. Covered securities futures contracts are those entered into on or after January 1, 2014.

- **Derivative-related options are deferred to 2016.** If an option, stock right, or warrant is issued as part of an investment unit (see above), reporting applies to the option, stock right, or warrant if it is acquired on or after January 1, 2016.

[Reg. §1.6045-1(m)(2); Reg. §1.6045-1(a)(14)]
- **Commodities and foreign currency are not specified securities, so options on them are not covered.** Basis reporting by a broker for an option on foreign currency or an option on a commodity is not currently required under §6045. However, non-1256 OTC options are reportable and see the discussion above on a foreign currency contract described in §988(c)(5) which is subject to reporting.

**B. Reporting options that are not 1256 contracts** [Reg. §1.6045-1(m)(4)]

- **Physical settlements.** The broker must adjust the basis of the acquired asset or the gross proceeds amount as appropriate to account for any payment related to the option, including the premium.

- **Cash settlements.** For an option that is settled for cash, gross proceeds on the 1099-B is all payments made or received on the option. Under Reg. §1.263(a)-4(c), acquisition costs are part of basis.

  - **Purchased option.** The basis is the premium paid plus any costs, including commissions, fees, or other transaction costs related to the purchase of the option. The gross proceeds is the amount received from settlement minus any costs related to the settlement of the option.

  - **Written option.** Report as gross proceeds the premium received decreased by any amounts paid on the option, including settlement payments, commissions, or other costs related to the closeout or cash settlement and report $0 as the basis of the option.

- **Warrants and stock rights acquired in a section 305 distribution.** When a right or warrant to acquire stock is received in the same account as the underlying security in a distribution that is described in §305(a), a broker is permitted, but not required, to apply the rules described in §305 and §307 when reporting or accounting for the basis of the option and the underlying equity. Under §305(a), gross income does not include the amount of any distribution of the stock of a corporation made to shareholders with respect to their stock. Under §307, the basis of the stock with respect to which nontaxable stock rights are distributed is allocated between the old stock and the stock rights in proportion to the fair market values of each on the date of distribution. The date of distribution is the date the rights are distributed to the stockholder, and not the record date.

  There is an exception to this allocation rule for nontaxable stock rights, in the case of rights whose fair market value is less than 15 percent of the fair market value of the stock in respect of which they are issued. Where this is the case, their basis is zero unless the taxpayer elects to allocate a portion of the basis of the old stock.

  Note that, under the final regulations, a stock right or a warrant purchased from the original recipient is treated as an option covered by the rules for physical or cash settled options as applicable. See above.
Multiple options documented in a single contract. 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 an option strategy such as a bear or bull call or put spread or collar involving more than one option, you report each option leg of the strategy not the unit. One commenter requested that if multiple option contracts are bundled into a single investment vehicle and the components cannot be separately exercised, the investment should be treated as a single instrument with a single basis. The IRS declined not adopt this comment because in their mind the basis of each financial instrument is required to be accounted for separately. [Reg. §1.6045-1(m)(5)]

Wash sales: The 2010 final regulations only require a broker to apply the wash sale rules when the transaction involves covered securities with the same CUSIP number. The final regulations did not change this rule when options are involved.

Backup withholding on options. Commenters asked for guidance on how to implement backup withholding for option transactions, asking whether a rule similar to §31.3406(b)(3)-2(b)(4) applies that would allow a broker to withhold at either the time of sale or upon a closing transaction or lapse. Concern was also raised on how to handle backup withholding on physically settled options or when the taxpayer transfers an option or ends up closing out an option transaction at a loss. The IRS did not address backup withholding rules, considering them outside the scope of the final reporting regulations. Withholding on these items will raise concerns without further guidance. We hope there will be more to come.

C. Reporting §1256 Contract Options

If a covered option is also a §1256 contract, a broker must treat the option as if it were a regulated futures contract subject to reporting as such under the mark-to-market rules. A broker is permitted, but not required, to report the amounts for options and the amounts for regulated futures contracts as a net amount for each reportable item. [Reg. §1.6045-1(m)(3)]

An option is subject to reporting under §6045 only if the option references one or more specified securities. For a non-equity option described in §1256(b)(1)(C) on one or more specified securities, the option would be reportable, but the broker is to apply the reporting rules that apply to a regulated futures contract, which are described in Reg. §1.6045-1(c)(5).

For §1256 options, a broker is to report the adjusted basis for a position that has been marked to market. [Reg. §1.6045A-1(b)(1)(vii)]

For an option on one or more specified securities that is not described in §1256(b)(1)(C), a broker is to report gross proceeds and basis in accordance with the rules in the final regulations for a non-section 1256 options discussed in B. above.
• **A nonequity option** is generally any option (other than a right to acquire stock from the issuer) that is traded on, or subject to the rules of, a qualified board or exchange (referred to as a "listed option"). However, as pointed out above, to be reportable on 1099-B even these options must be on specified securities.

• **Nonequity options do not include:** an option to buy or sell stock or an option the value of which is determined directly or indirectly by reference to any stock or any narrow-based security index.

• **Nonequity options include:** an option on a broad-based index as described in §1256(b)(1)(C). To determine whether an index substantially all the components of which are specified securities is a broad-based index under §1256(g)(6)(B), the Preamble to TD 9616 says that a broker must look to rules established by the Securities Exchange Commission and the Commodities Futures Trading Commission that determine which regulator has jurisdiction over an option on the index.

• **Penalty relief for determining index status.** The IRS sees that distinguishing narrow from broad based options is not always an easy task. The final regulations provide that penalties will not be asserted under §6721 and §6722 if a broker in good faith determines that an index is, or is not, a narrow-based index described in section §1256(g)(6) and reports in a manner consistent with this determination.

• **IRS gave no relief from wash sales or short sale applications to §1256 options.** A number of commenters suggested that neither the wash sale rules under §1091 nor the short sale rules described in §1233 should apply to a §1256 option and some asked for clarification about how holding period adjustments due to application of the wash sale provisions should be applied to section 1256 options. The IRS considered the comments substantive in nature and outside the scope of the reporting rules.

• **Watch for two reportable sales.** When a closing transaction for a contract described in §1256(b)(1)(A) involves making or taking delivery, there are two sales, one resulting in profit or loss on the contract, and a separate sale on the delivery.