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Proposed Cost Basis Regulations: *Debt Instruments & Options*

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Agenda

- Snapshot Introduction to the Proposed Regulations for Debt & Options
- Review of Phased Effective Dates for Cost Basis Reporting
- Focus on IRS flexibility to delay under letter of the law
- Critical Issues and Concerns for the Option Rules
- Critical Issues and Concerns for the Debt Rules
- Key Observations & Critical Take-Aways
- Questions & Answers from Attendees



Snapshot Introduction to Proposed Regs.

- Proposed Regs released on November 22, 2011
- Comments due [Feb. 23—90 days after Fed Reg publish date]
- Public Hearing scheduled for Friday, March 16, 2012
- Even if IRS quickly reviewed comments and rapidly revised and finalized regulations (within 90 days of hearing), final regulations not likely to be released until summer 2012 at earliest
- Final phase I & II regulations not released until October 2010
- Regulations cover cost basis reporting for debt & options
- Regulations expand transfer reporting rules for debt & options
- Regulations expand issuer reporting to require issuer reporting for corporate action type events relating to debt & options (Form 8937 instructions & Notice 2012-11 raise concerns regarding whether brokers will receive all necessary information from issuers)

Phased Effective Dates for Cost Basis Reporting

- Statute Enacted Oct. 2008
- Three staggered effective dates:
 - Stock acquired on or after Jan. 1, 2011
 - Mutual Fund & Dividend Reinvestment Plan (DRP) stock acquired on or after Jan. 1, 2012
 - Debt & Options acquired on or after Jan. 1, 2013
- Plus, may add other designated securities (Jan. 1, 2013 or later)
- Final regulations for stock on Oct. 12, 2010
- Transfer reporting delayed until January 2012 per Notice 2010-67
- Issuer reporting for corporate actions during 2011 effectively delayed to Jan. 17, 2012 per Notice 2011-18
- Form 8937 & Instructions issued Jan 5, 2012, & transition relief provided Jan 13, 2012 per Notice 2012-11



Effective Dates for Option and Debt Reporting

- Option reporting “shall not apply to any option which is granted or acquired before January 1, 2013.”
- Debt basis reporting is required by “January 1, 2013, or such later date determined by the Secretary.”
- Basis reporting for securities other than stock, mutual funds, or debt (e.g., commodities, commodities derivatives, or other financial instruments), requires a determination by the Secretary that adjusted basis reporting is appropriate.
 - The Secretary has not made (or proposed) any such determinations.



Request to Delay Basis Reporting for Debt

- Last December, Wolters Kluwer Financial Services asked the IRS to delay, by at least one year, basis reporting for debt instruments.
 - Basis reporting for debt is more difficult than basis reporting for stock
 - Data to project a payment schedule for debt often is hard to obtain
 - Investors may elect a variety of different accrual methods for debt
 - For stocks, but not for debt, many brokers had preexisting basis reporting systems
- Other stakeholders reportedly will ask the IRS to delay basis reporting for debt by at least a year after the finalization of the proposed regulations for debt.
- Government staffers appear sympathetic, but want to hear from more stakeholders
 - Requests for delay should explain why the delay is necessary





When Will the IRS Decide?

- Comments on the proposed regulations (including the proposed effective dates) are due February 23, 2012.
- Public hearing is scheduled for March 16, 2012.
- Final regulations must be issued before January 1, 2013.



Option Taxation Overview

- Different Option Types—Includes Rights & Warrants
 - Corporation issues on own stock (exchange-traded or not)
 - Clearinghouse acts as intermediary (exchange-traded options)
 - Direct counterparty and over-the-counter (OTC) options
- Different tax rules
 - Some Section 1256 options
 - Some options issued on stock & Section 307 applies
 - Other options (compensatory options)
- Guidance Needs
 - Define covered options
 - Cash vs. physical settlement
 - Required basis adjustments
 - Issuer reporting
 - Transfer reporting



Options—Which are Subject to Cost Basis Reporting?

- Scope of options subject to cost basis reporting:
- Options on stock & debt (or other specified securities)
 - Includes options on stock or debt indices
- Options on financial attributes of stock and debt (or other specified securities), such as interest rates or dividend yields
- “Compensatory options” are excluded—what is a compensatory option?
- Options not subject to cost basis reporting includes options on commodities or commodity futures (such options don’t satisfy the standards set forth above)
- Options not subject to cost basis reporting would also generally include options that relate to assets that are not stock or debt
- Options that do not appear subject to cost basis reporting but there is some uncertainty—options on unit investment trusts or publicly traded limited partnerships that hold investments in stock or debt—concern is whether such options are options on financial attributes of the underlying stock and debt



Options Regulatory Overview

Overview of Unanswered Cost Basis Questions for Options in Proposed Regulations:

- By negative inference, cost basis reporting rules apply all options other than compensatory options including foreign options and over-the-counter options
- Rights and warrants are explicitly treated as options—foreign rights and warrants could result in challenges
- No clarification on how to report basis or mark-to-market adjustments for Sec. 1256 options
- No clarification on wash sale carve-out for Sec. 1256 options
- No clarity regarding whether broker must make basis adjustments for optional basis allocation for rights and warrants under Section 307
- Regulations impose issuer reporting on options exchanges for corporate actions on options and taxation is unclear



Options Regulatory Overview

Industry Challenges for Cost Basis Reporting for Options:

- Data issues for foreign options, rights & warrants and OTC options
- Data for stock will need to identify if stock was obtained pursuant to exercise of an option
- Transfer data will need to be updated to provide additional data related to the underlying security
- Transfer data for stock needs to indicate if stock obtained thru exercise of compensatory option
- Adjustments for corporate actions in options may create reporting issues



Debt Instruments—Which are Covered?

- ALL debt instruments subject to cost basis reporting with 2 exceptions for:
 - Section 1272(a)(6) debt (REMIC, & most mortgage-backed & asset-backed securities)
 - Certain debt with a term of 1 year or less that meets requirements of Treas. Reg. 1.6045-1(c)(3)(vii)(C)
- New definition of “debt instruments” and cross-reference to definition in original issue discount (OID) regs in Proposed Regs could lead to 1099-B reporting for some securities that brokers may have not treated as “debt obligations” subject to 1099 reporting under existing regs
- Examples of types of covered debt: US Gov’t Securities; Public Corporate Securities; Privately Placed Debt; Certificates of Deposit; Loans; Municipal Debt; Foreign Debt; Contingent Debt

Regulations Require New Calculations by Brokers

- A broker must make the following adjustments in computing the cost basis for debt (in addition to adjustments for wash sales and corporate actions):
 - Compute accrued market discount & report on sale
 - Compute original issue discount (OID) and increase basis
 - Compute amortizable bond premium and decrease basis
 - Compute acquisition premium and decrease basis
 - Decrease basis for any payment on debt other than qualified stated interest (QSI)

Basis Adjustments for Debt 101

■ Original issue discount (OID)

- Reduced purchase price that results in a discount equivalent to interest
- Zero coupon bond with \$100 paid at maturity in 10 years
- Sold at an initial issue price of \$60
- \$40 discount is OID (provides investor with yield equivalent to interest)

■ Plain vanilla 10 year bond sold with an interest coupon pegged to appropriate market yield (4%)

■ Market discount

- Reduced purchase price that results in a discount to compensate for change in yield for the debt between date of issue and current market
- Market yield for plain vanilla debt is 6% at the end of year 4
- \$100 principal 4% coupon 10 year bond now is purchased at \$88
- Bond is sold at end of year 6 for \$93--\$4 of market discount has accrued
- Gain of \$5 (\$93 less \$88 basis)
- \$4 of gain is market discount ordinary income, remaining \$1 is long-term capital gain



Basis Adjustments for Debt 101 (continued)

■ Bond premium


- Increased purchase price that results in reduced yield (below stated coupon) to compensate for change in yield for the debt between date of issue and current market
- Market yield for plain vanilla debt at end of year 4 is 3%
- \$100 principal 4% coupon 10-year bond now is purchased for \$106
- Bond premium on taxable bonds only amortized if taxpayer elects
- If no election, basis unchanged and \$6 long-term capital loss on maturity (\$100 proceeds less \$106 basis)
- Amortization amount for year offsets interest income (above the line)
- Amortization amount reduces basis
- At maturity (or appropriate call date as determined under special tax rules that differ from financial analysts worst call rule)—no gain or loss and basis equals \$100
- Amortization of bond premium on tax-exempt bonds is mandatory

■ Acquisition Premium

- OID bond adjusted issue price is now \$84 and new investor buys for \$86

Calculations Methodology Requirements

- Use consistent accrual methods for OID & market discount if applicable
- Use same OID accrual period used for OID reporting on Form 1099-OID; If not, use accrual period equal to interval between principal or interest payments that is one year or less
- Brokers must amortize bond premium and reduce basis regardless of whether customer has elected to amortize bond premium
- Brokers must amortize market discount under constant yield method even if customer has not made the related election
- Customers are not bound by brokers assumptions
- Sales between interest payment dates—accrued interest must be separately stated



Key Observation: Calculations Apply to Almost All Debt Held by Brokers—Not Just OID Debt

- Bond premium and market discount rules apply to all debt—not just OID debt so brokers must make these adjustments to potentially all debt (other than the two excepted types—short-term & 1272(a)(6))
- Inference that accrued interest must be separated from gross proceeds on sales between payment dates—transfer reporting regulations require this break-out on transfer of debt instruments: broker's systems will likely need to be modified to make these calculations for events that are not sales

Requires Application of Special OID Rules

- Proposed Regs require brokers to compute OID & increase basis for debt under Code Sections 1271-1275 and 6049—there are a lot of special rules in regulations
- Final regulations under Code Section 1275 include special OID rules for certain types of debt securities that must be applied:
 - Variable rate debt
 - Contingent debt
 - Tax-exempt municipal debt
 - Inflation-indexed debt
 - Foreign currency denominated debt (Section 988)
- Proposed Regs reference QSI, which is different from stated interest. Stepped interest rates and “long” first coupons raise and other exotic features can result in stated interest not qualifying as QSI. Brokers will need to make these determinations and then apply OID under these special circumstances
- Final regulations under the bond premium rules of Section 171 include special rules relating to call features and tax-exempt municipal debt
- There are no final regulations addressing core mechanical rules for market discount
- OID and market discount rules have *de minimis* tests and exceptions that must be computed

Corporate Actions & Transfer Reporting

- Issuers of debt will be subject to cost basis issuer reporting and brokers will be required to make adjustments due to corporate actions on debt
- Under transfer reporting rules, the Proposed Regs require a transferring broker to report the following information for debt:
 - 1. A description of the payment terms;
 - 2. The issue price of the debt instrument;
 - 3. The issue date;
 - 4. The adjusted issue price of the debt instrument as of the transfer date;
 - 5. The customer's initial basis in the debt instrument;
 - 6. The yield used to compute any accruals of OID, bond premium and/or market discount;
 - 7. Any market discount that has accrued as of the transfer date; and
 - 8. Any bond premium that has been amortized as of the transfer date.
- The payment terms requirement could prove troublesome for some complex or variable rate debt instruments because it could require a broker to provide many additional elements in order to fully describe the debt instrument's payment terms
- The adjusted issue price, accrued market discount and bond premium elements raise significant potential reconciliation concerns because subtle differences in calculation methods between the transferring broker and the receiving broker might result in the amounts accrued as of the transfer date not precisely aligning



Critical Take-Aways

- Proposed Regulations impose substantial burdens on brokers for both options & debt
- Requiring brokers to calculate and take into account market discount and bond premium on debt creates substantial new reporting burdens
- Requiring cost basis reporting for almost all types of debt adds significant additional development complexities and reporting obligations due to special tax rules for many types of debt instruments
- Expanded transfer reporting rules create new data challenges
- Scope of new reporting burdens and expected release date for final regulations makes timely compliance in 2013 highly unlikely



Questions & Answers

- Participants can submit questions at this time
- Questions will be answered, time permitting
- Submitted questions will be reviewed and we will attempt to answer many of them and provide a follow-up question and answer document



Considerations

- Wolters Kluwer Financial Services does not provide tax advice. You should consult your own tax advisers and they (and not Wolters Kluwer Financial Services, GainsKeeper or Capital Changes) are solely responsible for any tax, tax penalties or interest related to their tax returns
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