

MEMO# 25669

November 29, 2011

IRS Issues Proposed Regulations on Cost Basis Reporting for Debt and Options

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TO: BDAC COST BASIS REPORTING TASK FORCE No. 38-11
BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 73-11
BROKER/DEALER ADVISORY COMMITTEE No. 79-11
OPERATIONS COMMITTEE No. 49-11
SMALL FUNDS COMMITTEE No. 52-11
TAX COMMITTEE No. 74-11
TRANSFER AGENT ADVISORY COMMITTEE No. 99-11 RE: IRS ISSUES PROPOSED
REGULATIONS ON COST BASIS REPORTING FOR DEBT AND OPTIONS

The Internal Revenue Service (“IRS”) recently released proposed regulations addressing cost basis reporting by brokers for transactions related to debt instruments and options. [\[1\]](#) Brokers will be required to report to customers and the IRS cost basis information for debt instruments acquired, and options granted or acquired, on or after January 1, 2013.

The general rules under sections 6045 (Returns of Brokers), 6045A (Information Required in Connection with Transfers of Covered Securities to Brokers), and 6045B (Returns Relating to Actions Affecting Basis of Specified Securities) will apply to a debt instrument or an option that is a covered security. These proposed regulations thus amend the regulations under such sections to incorporate debt instruments and options into the existing rules on cost basis reporting. Other than a few substantive changes affecting all securities (described below), these proposed regulations do not affect cost basis reporting for mutual fund shares.

Options

The proposed regulations add certain options to the definitions of “security,” “specified security,” and “covered security” in Treas. Reg. § 1.6045-1. In general, an option on one or more specified securities, including an index of such securities or financial attributes of such securities, that is granted or acquired on or after January 1, 2013, will be a covered security. The definitions for the terms “closing transaction” and “sale” also have been updated to be made consistent with sections 1234 and 1234A. The cancellation, lapse,

expiration, or other termination of an option will be a closing transaction, as will cash settlement.

Reporting requirements for an option that is a covered security will depend on whether or not the option is physically settled. If an option is physically settled, the broker for the asset purchaser must adjust the basis of the purchased asset by the premium paid. Similarly, the broker for the asset seller must adjust reported proceeds by the premium received. If an option that is a covered security is sold or is part of a closing transaction that does not involve physical settlement, the broker must report gross proceeds and whether the gain or loss is long-term or short-term.

Debt Instruments

The proposed regulations also amend Treas. Reg. § 1.6045-1 to include a debt instrument in the definition of “specified security” and a debt instrument acquired for cash in an account on or after January 1, 2013, in the definition of “covered security.”

For purposes of Treas. Reg. § 1.6045-1, the proposed regulations define a debt instrument as any instrument described in Treas. Reg. § 1.1275-1(d) and any instrument or position that is treated as a debt instrument under a specific provision of the Internal Revenue Code. Solely for purposes of these regulations, a security classified as debt by the issuer is treated as a debt instrument. If the issuer has not classified the security, the security is not treated as a debt instrument unless the broker knows that the security reasonably is 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. The proposed regulations provide that a debt instrument described in section 1272(a)(6) (debt instruments with principal subject to acceleration) is not a covered security.

For a debt instrument that is a covered security, brokers must 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. Brokers also must report the amount of any market discount that has accrued as of the date of a sale or transfer of a debt instrument.

In order to simplify and standardize information reporting, the proposed regulations provide that brokers generally are required to calculate amounts relating to OID, bond premium, acquisition premium, and market discount by assuming that the customer has not made any elections with respect to the debt instrument. The proposed regulations contain two exceptions to this general rule, however. First, 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. Second, a broker must assume that the customer has elected to amortize bond premium on a taxable debt instrument under section 171. [\[2\]](#)

A broker generally must use a consistent accrual period to determine the accruals of discount or premium on a debt instrument. 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.

These proposed regulations apply only for information reporting purposes under section

6045. A customer can use any method or make any election permitted under the relevant provisions of the Internal Revenue Code and regulations and is not bound by the assumptions that the broker uses to satisfy its reporting obligations under section 6045. Notwithstanding the information reported by a broker, a customer still must comply with all relevant tax laws. If a customer uses an assumption or method different from that used by the broker for information reporting purposes, the customer must reconcile the amount reported on the Form 1099-B to the amount reported on the customer's tax return.

Transfer Reporting for Options and Debt Instruments

The information that brokers must provide on transfer statements with respect to stock under Treas. Reg. § 1.6045A-1(a)(14) also must be provided with respect to transfers of debt instruments and options under the proposed regulations. The proposed regulations also include additional information specific to debt instruments or options. With respect to debt instruments, the broker must provide on the transfer statement:

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

With respect to options, the broker must provide on the transfer statement:

- a. The date of grant or acquisition of the option;
- b. The amount of premium paid or received; and
- c. Any other information required to fully describe the option.

The transferring broker may provide a single identifier, such as a CUSIP number or Options Clearing Corporation number or code, that can be used by the transferee broker to identify the security and its related terms.

Issuer Reporting for Options and Debt Instruments

The proposed regulations provide that if an organizational action by an issuer of a security underlying an option 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 Treas. Reg. § 1.6045B-1.

Changes Affecting All Securities

The final cost basis regulations under section 6045 permit a broker to 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. The IRS received comments that this choice should be eliminated in order to standardize broker reporting on Form 1099-B and taxpayer reporting on Form 1040. The proposed regulations adopt this request and require brokers to reduce reported gross proceeds by commissions

and transfer taxes related to a sale of covered securities sold on or after January 1, 2013.

The final regulations also require a broker to 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 amend this exclusion to clarify that the exclusion applies only to the broker receiving custody of a transferred security. The proposed regulations thus require that a broker transferring a security must reflect all necessary adjustments for organizational actions taken through and on the transfer settlement date when completing a transfer statement.

The proposed regulations under Treas. Reg. § 1.6045A-1 modify the existing list of information that must be included on a transfer statement by adding information about whether the security was acquired through an equity-based compensation arrangement.

Comments Requested

The IRS has asked for comments on the proposed regulations by February 23, 2012. A public hearing has been scheduled for March 16, 2012. If you have any comments on the proposed regulations, please provide them to me (202-371-5432 or kgibian@ici.org) no later than Thursday, January 19, 2012.

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endnotes

[1] The proposed regulations can be found on the U.S. Government Printing Office website at: <http://www.gpo.gov/fdsys/pkg/FR-2011-11-25/pdf/2011-30383.pdf>.

[2] The Treasury Department and the IRS recognize that the section 171 election assumption is inconsistent with the rule under section 6049 prohibiting a payor from taking premium into account for purposes of reporting a holder's interest or OID income on Forms 1099-INT or 1099-OID each year. The government believes, however, that most holders will make a section 171 election, and therefore this assumption will result in fewer instances in which a customer will need to reconcile the reported adjusted basis number to the proper number.