



# Understanding the Challenges of CBRL for Debt & Options

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Wolters Kluwer Financial Services

# Agenda

- Cost Basis Reporting Law
- Debt Instruments Basis Calculations
- Put/Call Rules
- Elections
- Phase 3 Regulatory Reporting

# Cost Basis Reporting Overview

- The Emergency Economic Stabilization Act of 2008 includes a provision requiring brokers to expand information reporting in connection with securities sales to include the adjusted cost basis of securities sold and whether the related gain or loss is long term or short term.
- The legislation is rolled out in three phases, which started in 2011. The effective dates of covered securities are:
  - Equity securities acquired on or after January 1, 2011 (Phase 1)
  - Mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012 (Phase 2)
  - Debt securities, options, and other financial instruments acquired on or after January 1, 2014 (Phase 3)
- Broker reporting of cost basis creates significant challenges for brokers.

# Delayed/Lagged Transfer Reporting

The IRS final regulations specify that cost basis reporting rules for debt securities have the following effective dates:

- **Phase 3 - Part 1:** This phase includes less complex debt (LCD), specified options, and single stock futures (SSFs) acquired on or after January 1, 2014. Transfer reporting rules for less complex debt, specified options and SSFs apply to transfers that occur on or after January 1, 2015.
- **Phase 3 - Part 2:** More complex debt (MCD) and options that are part of investment units acquired on or after January 1, 2016. Transfer reporting for more complex debt applies to transfers occurring on or after January 1, 2017.

# One Year Lag in Transfer Reporting

- Most importantly, the Final Phase 3 Regs delay the effective dates for transfer reporting so that they lag one year after the related covered security date
- LCD, Specified Options and SSFs are subject to transfer reporting beginning with transfers occurring on or after Jan. 1, 2015
- MCD is subject to transfer reporting beginning with transfers occurring on or after Jan. 1, 2017
- Options that a broker determines are Section 1256 options are not subject to transfer reporting at all under the Final Phase 3 Regs
- Under the regulations, a receiving transferee is permitted to treat debt and options that would otherwise constitute covered securities received before these lagged transfer reporting effective dates as noncovered

# Over-Arching Concerns

Development, regulatory and data issues are significantly more difficult than either prior phase of the cost basis rules:

- Operations teams and developers lack tax regulatory knowledge necessary to architect, implement and manage the needed systems for regulatory compliance
- Security master data likely inadequate for required tax classifications and calculations
- Corporate actions, security conversions, bankruptcies pose unique challenges
- Greater customer knowledge and likely customer service issues from holders of debt and options: sophisticated investors and all options investors and traders (the shock of 1099s)

# Debt Classifications

The final cost basis regulations use the following classifications to categorize debt securities:

- Less Complex Debt (Phase 3: Part 1)
- More Complex Debt (Phase 3: Part 2)
- Excluded Debt

# Less Complex Debt

The following securities are classified as Less Complex debt:

- Corporate Debt with Sinking Fund Schedule Processed via Factorization
- Fixed Rate Government and Corporate Debt Denominated in US Dollars
- Fixed Rate US Municipal Debt
- Fixed Rate US Securities with Put or Call Schedules
- Pre-Refunded Securities



# More Complex Debt

The following securities are classified as More Complex debt:

- Non US Issue or Non US Dollar Denominated Debt
- Variable or Adjustable Rate Debt
- Step Bonds - Includes Zero Coupon to Fixed Rate
- Payment-in-Kind (PIK) Bonds
- Contingent Payment Debt Instruments (CPDIs)
- Treasury Inflation Protected Securities (TIPs)
- Tax Credit Bonds
- Stripped Securities
- Investment Unit of Debt with Attached Warrant
- Convertible Bonds (no contingent feature)

# Excluded Debt

The following securities are classified as Excluded debt:

- 1272(a)(6) - Factored Debt
- Short Term - One Year or Less from Issue Date to Maturity Date
- Structured Debt - Security with Imbedded Put Option on Underlying Investment

# Debt Final Regs Require Segregating into 4 categories for accurate processing

Security Tax Classification	Jan 1, 2014	Jan 1, 2016
Less Complex Debt (LCD)	Covered	
More Complex Debt (MCD)		Covered
Excepted Complex Debt (ECD)	Not covered	
Not Debt For Tax Purposes (NDT)	Either covered stock or not Covered	

# Summary of the Primary Segregation Rules for Options

Type	Covered Status
SO <sup>[1]</sup>	If acquired on or after Jan. 1, 2014
MTMO	If acquired on or after Jan. 1, 2014
IUO	If acquired on or after Jan. 1, 2014
XO	Never—nonspecified—not covered regardless of acquisition date or manner
SRW	If acquired on or after Jan. 1 2014 BUT broker can choose whether to apply special basis adjustment rules of Section 307 to such options and the related stock (but this only applies if stock rights or warrants are received in nontaxable transactions governed by Sec. 305; holding period rules must still be tracked in all cases for rights and warrants)

<sup>[1]</sup> Excluding 1256 options

# Debt Instruments Basis Calculations

Primary debt instrument adjustments:

- Original Issue Discount (OID)
- Acquisition Premium
- Bond Premium
- Market Discount
- Income Reallocations - Principal Repayments
- De Minimis

# Original Issue Discount

- Original Issue Discount (OID) is the excess of the Stated Redemption Price at Maturity (SRPM) over the issue price.
- OID is included in income over the term of the debt instrument as it accrues under the constant yield method.
- Different OID rules apply to short-term debt and stripped debt
- *De minimis*: If OID is less than .0025 times the SRPM times the number of complete years to maturity:
  - OID is treated as zero and all interest is treated as QSI
  - *De minimis* test does not apply to tax-exempt bonds
- Qualified Stated Interest (QSI) is defined as interest that is:
  - Unconditionally payable
  - Payable in either cash or property
  - Payable at least annually
  - Payable at a single fixed rate or qualified variable rate

# OID Illustration

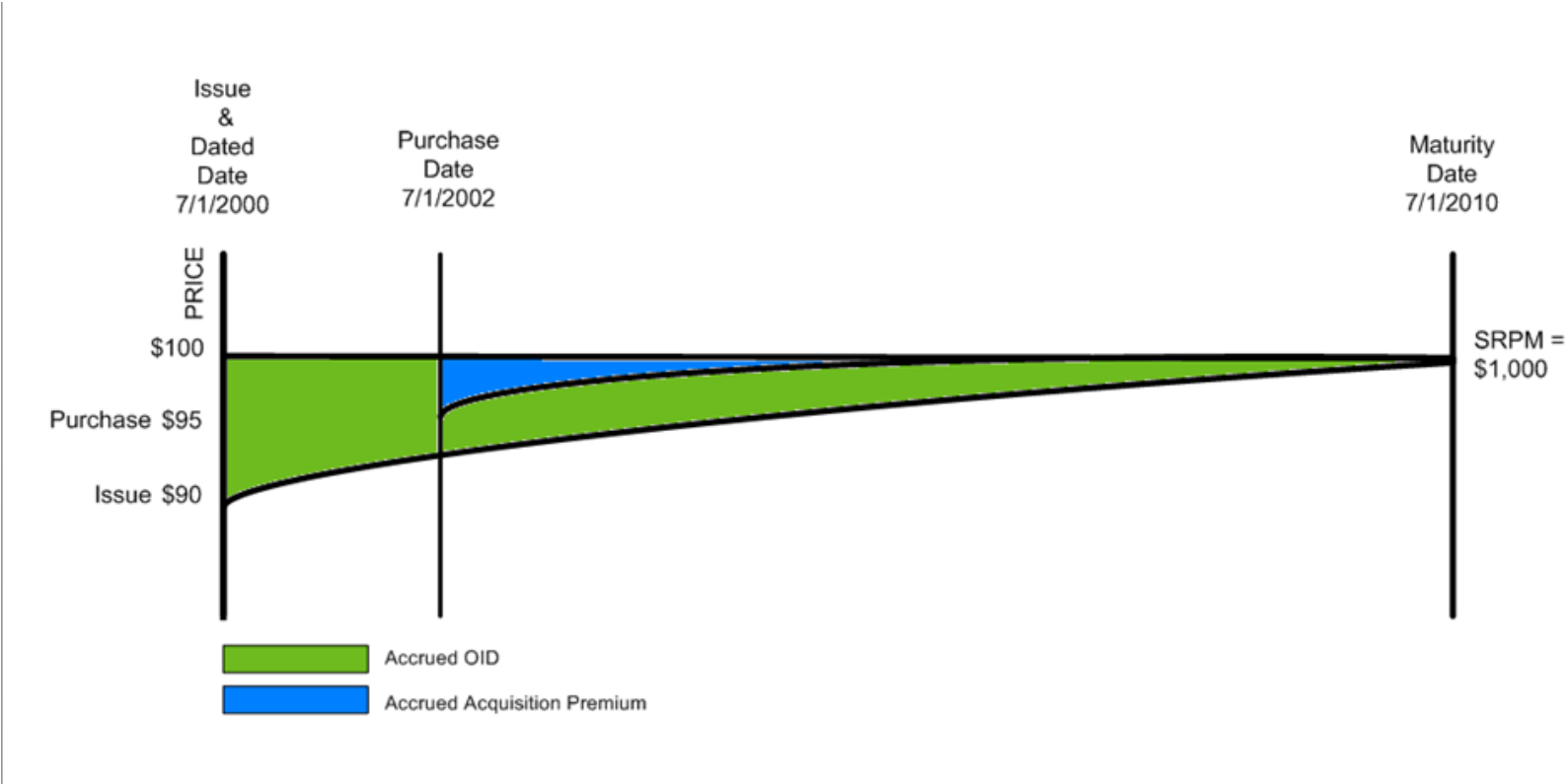


# Acquisition Premium

- A secondary market purchase immediately after which the taxpayer's basis is less than the SRPM and greater than the adjusted issue price.
- Acquisition premium is accounted for as a pro rata offset to remaining OID, i.e. the amount of OID included in income is reduced by the acquisition premium for the period.
- Note: OID is calculated on a constant yield method (based on compounding) and acquisition premium is straight-line (unless All-OID election is made)



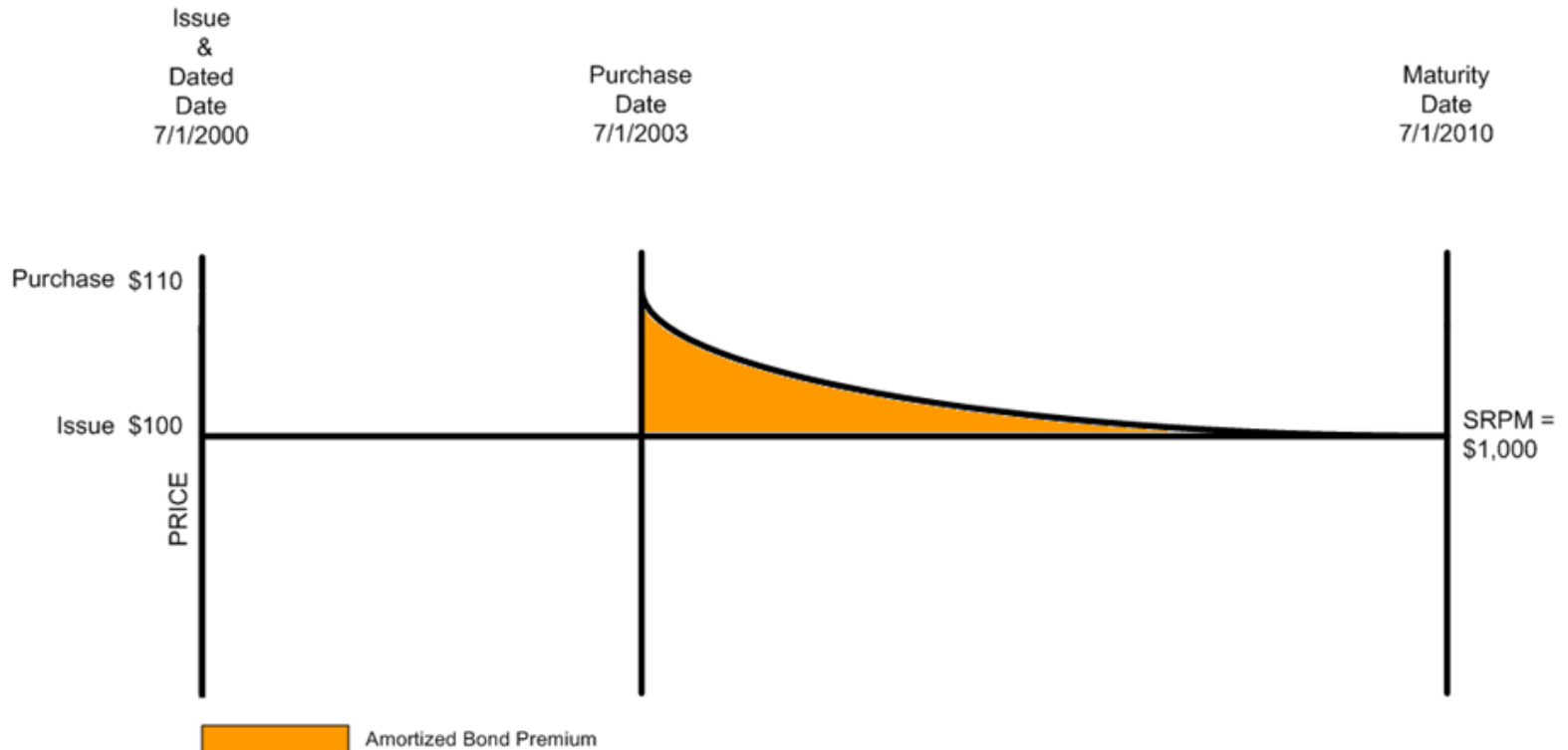
# Acquisition Premium Illustration



# Bond Premium

- Bond Premium occurs when a security is purchased over the SRPM of the bond.
- Bond premium is amortized as an offset to interest income over the term of the debt.
- Bond premium is amortized using the constant yield method.
- Different rules for taxable and tax-exempt bonds
  - Amortization mandatory for tax-exempt bonds
  - Election for taxable bonds
  - Calculation period differs for based on different put/call rules (Reg. 1.171-3)

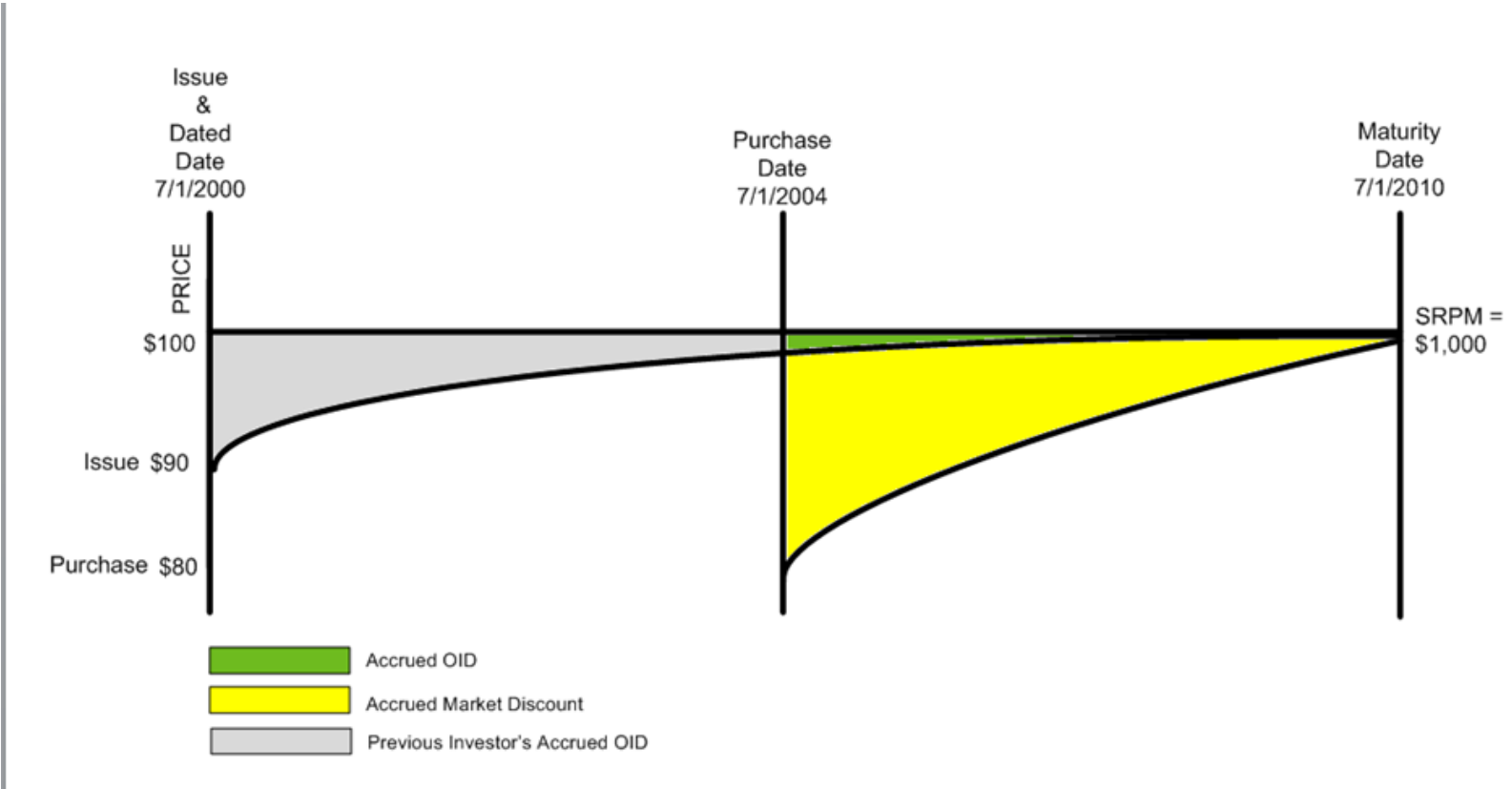
# Bond Premium Illustration



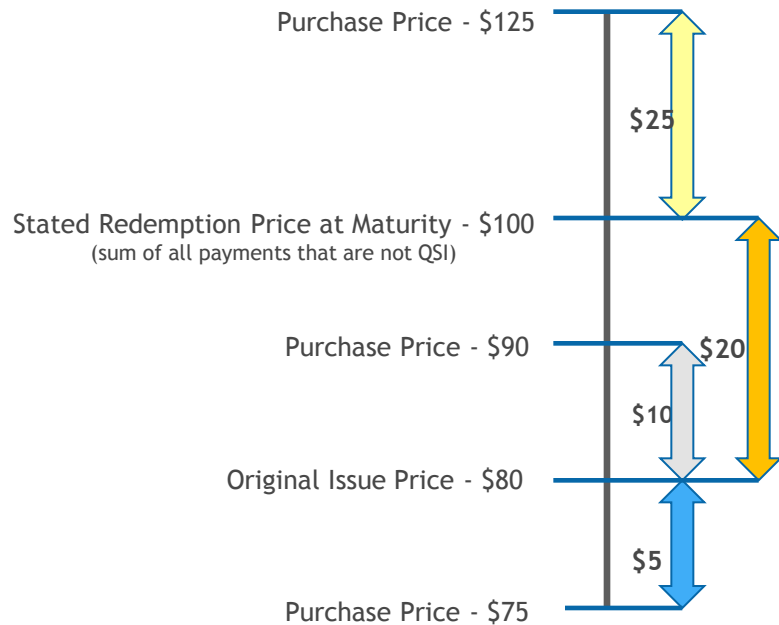
# Market Discount

- A secondary market purchase in which:
  - If the security was issued OID, the purchase is below the adjusted issue price of the security.
  - If the security was issued without OID, the purchase price is below the SRPM of the security.
- Market Discount (MD) is accrued ratably or by constant yield with election.
- Market Discount does not require current accrual, and allows for deferral until principal payments are received, sale or disposition, or at maturity.
- *De minimis*: If MD is less than .0025 times the SRPM times the number of complete years from purchase to maturity:
  - MD is treated as zero.

# Market Discount Illustration



# Final Regulations Require 4 Core Debt Adjustments



- 1) **Bond Premium** - the excess of the purchase price of a debt instrument over the stated redemption price at maturity
- 2) **OID (Original Issue Discount)** - the excess of the stated redemption price at maturity over the issue price
- 3) **Acquisition Premium** - A purchase after which the taxpayer's basis is immediately less than the stated redemption price at maturity but greater than the adjusted issue price
- 4) **Market Discount** - If a bond's value declines after it is issued, a purchaser will acquire the debt instrument with market discount

# Put/Call Rules

- An issuer of a debt instrument having a call option will be presumed to exercise such option if doing so would lower the yield to maturity of the debt instrument
- Conversely, a holder having a put right will be presumed to exercise such right if doing so would raise the yield to maturity
- If a debt instrument has multiple put or call options, the call option that produces the lowest yield is presumed exercised (if such yield is lower than the yield to final maturity), and the put option that produces the highest yield (if a higher than the yield to final maturity) is presumed exercised
  - If a debt instrument has both put and call options, the rules are applied to the options in the order they may be exercised
- Data needs to show entire put/call schedule, not just next put or call date as used in finance

## Put/Call Rules - *Continued*

Debt Type	Yield Calc OID	Yield Calc BP	Yield Calc MD
Taxable Bonds	Yield to Worst (Lowest Yield)	Yield To Best (Highest Yield)	Yield to Worst (Lowest Yield)
Tax-exempt Bonds	Yield to Worst (Lowest Yield)	Yield to Worst (Lowest Yield)	Yield to Worst (Lowest Yield)
Pre-refunded	Yield to Pre-refunded Call	Yield to Pre-refunded Call	Yield to Pre-refunded Call



# Elections for Debt

- The Phase 3 Final Regulations require brokers to support five specific customer elections:
  - Bond Premium Amortization Election
  - Market Discount Constant-Yield Election
  - Market Discount Current Inclusion Election
  - All OID Election
  - End of Period Translation Election
- In general, the Phase 3 Final Regulations assume that none of the elections have been made unless the customer has notified the broker, with the exception of the bond premium amortization election for taxable debt.

# Bond Premium Amortization Election

- Election to amortize (or not amortize) bond premium for taxable bonds.
- Final regulations require brokers to assume that customers have made the election to amortize bond premium, unless the customer has notified the broker otherwise.
- Election applies to all taxable bonds held during the year the election was made.
- Election may be revoked with IRS consent.

# Market Discount Constant-Yield Election

- Election to accrue market discount using the constant-yield method rather than the ratable(straight-line) method.
- Instrument-by-instrument election that must be made for the tax year the debt instrument is acquired.
- Election cannot be revoked.

# Market Discount Current Inclusion Election

- Election to currently include Market Discount in income and make corresponding basis adjustments.
- Election applies to all bonds acquired during the year of election.
- Election may be revoked with IRS consent.

# All OID Election

- Election to treat all interest as OID.
- Instrument-by-instrument election applicable in the year of acquisition.
- Election may be revoked with IRS consent.
- Election applies only to taxable debt.
  - Results in Acquisition Premium being accrued using the constant yield method.
  - Results in current year amortization for bond premium.
  - Results in current inclusion of Market Discount for all debt acquired at Market Discount and a constant yield accrual Market Discount election for that debt.

# End of Period Translation Election

- Election to translate nonfunctional foreign currency interest and expense at the spot rate on the last day of the accrual period or tax year.
- Election applies to all taxable debt held during the year the election is made.
- Election may be revoked with IRS consent.

# Current Tax Reporting for Options

- Brokers do not generally currently provide tax reporting for options OR single stock futures
- Brokers are not currently required to take into account the tax rules relating to options or the impact of physical settlement of options under the tax law
- Corporate actions relating to the underlying stock or security associated with an option often result in significant changes to the terms of an option—there is no existing tax law requirement to monitor or take into account these changes from a tax standpoint (and there is essentially no applicable tax law guidance)
- Options are subject to the wash sale rules and can also have an effect or be affected by acquisitions and sales of the stock or security associated with the option

# Single Stock Futures

- Brokers required to provide Form 1099-B reporting of both proceeds and basis relating to single stock futures
- There are special tax rules that can affect the calculation of basis and long-term/short-term gain/loss characterization for single stock futures that are set forth in both Sec. 1234B and the wash sale rules of Sec. 1091



# Wash Sales

- **WASH SALES CONSIDERATIONS:** Brokers must adjust the basis and holding period of debt instruments and options for wash sales under the simplified single account/identical security wash sale rule of Section 6045(g)(2)(B)(ii). These rules can affect the time value of money tax calculations for debt because of their effect on basis. Even when they don't impact such time value of money calculations, the effect of wash sale related basis adjustments under Section 1091(d) (along with the related holding period adjustments) must be applied in calculating basis for covered debt, options and SSFs.
- **HIGHLIGHT:** *Broker could easily overlook the impact of wash sale basis adjustments on determining tax calculations of OID, bond premium, market discount and acquisition premium on debt instruments with resulting incorrect reporting of basis and other adjustments on Forms 1099-B, INT & possibly OID.*

# Phase 3 Regulatory Reporting Topics

- Review of 2014 1099 reporting requirements
  - 1099-B
  - 1099-OID
  - 1099-INT
- Discussion of key issues and concerns
- Transfer Reporting

# Big Picture Issues with 1099 Reporting

- Consistency with prior reporting?
- Regulatory compliance with current reporting
- Customer questions about changes in reporting
- Wildcard of late changes to the forms

# Concerns with Form 1099-B

- Ordinary Income Reporting
  - Different types of ordinary income
    - Market discount (Sec. 1.6045-1(n)(6))
    - CPDI, Sec. 988?
    - Possible checkbox if market discount is included in income?
- Options
  - Non-Sec. 1256
  - Sec. 1256
- Securities Futures Contracts
- Other changes?

# Concerns with Form 1099-B

- Form 1099-B only covers transactions for cash
- Form 1099-B only covers transactions in or converted to U.S. Dollars
- How should transactions that affect basis or result in gain or loss, but which are not reported on Form 1099-B, affect subsequent computations?
  - 1234B and 988 recognition events (transformations into physical)

# The New Form 1099-B - Ordinary income reporting changes

7979

VOID  CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Date of sale or exchange		OMB No. 1545-0715		<b>Proceeds From Broker and Barter Exchange Transactions</b>	
		1b Date of acquisition		2013			
		1c Type of gain or loss Short-term <input type="checkbox"/> Long-term <input type="checkbox"/>		Form 1099-B			
PAYER'S federal identification number		RECIPIENT'S identification number		2a Stocks, bonds, etc.		2b Check if loss not allowed based on amount in box 2a <input type="checkbox"/>	
				Reported to IRS } <input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less commissions and option premiums			
RECIPIENT'S name		3a Realized accrued market discount		3 Cost or other basis		4 Federal income tax withheld	
Street address (including apt. no.)				5 Wash sale loss disallowed		6 Check if:	
City, state, and ZIP code				7 Bartering		a <input type="checkbox"/> Noncovered security b <input type="checkbox"/> Basis reported to IRS c <input type="checkbox"/> Basis adjusted for accrued market discount	
Account number (see instructions)		2nd TIN not. <input type="checkbox"/>		9 Profit or (loss) realized in 2013 on closed contracts		10 Unrealized profit or (loss) on open contracts—12/31/2012	
CUSIP number				11 Unrealized profit or (loss) on open contracts—12/31/2013		12 Aggregate profit or (loss) on contracts	
						13 State	
						14 State identification no.	
						15 State tax withheld	

**Copy A**  
For Internal Revenue Service Center  
File with Form 1096.  
For Privacy Act and Paperwork Reduction Act notice, see the 2013 General Instructions for Certain Information Returns.



Form 1099-B

Cat. No. 14411V

Department of the Treasury - Internal Revenue Service

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# The New Form 1099-B - Securities Futures Contracts reporting changes

7979

VOID  CORRECTED

**Note:** Under sec. 1234B(b), except as provided under certain regulations, if gain or loss on the sale, exchange, or termination of a securities futures contract to sell property is considered as gain or loss from the sale or exchange of a capital asset, such gain or loss shall be treated as short-term capital gain or loss.

1f Gain or (loss) realized on closed SECs

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Date of sale or exchange	OMB No. 1545-0715	
		1b Date of acquisition	2013 Form 1099-B	
		1c Type of gain or loss Short-term <input type="checkbox"/> Long-term <input type="checkbox"/>		
		1d Stock or other symbol		
RECIPIENT'S identification number		2a Stocks, bonds, etc.	Reported to IRS <input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less commissions and option premiums	2b Check if loss not allowed based on amount in box 2a <input type="checkbox"/>
RECIPIENT'S name		3 Cost or other basis	4 Federal income tax withheld	<b>Copy A</b> For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2013 General Instructions for Certain Information Returns.
Street address (including apt. no.)		5 Wash sale loss disallowed	6 Check if: a <input type="checkbox"/> Noncovered security b <input type="checkbox"/> Basis reported to IRS	
City, state, and ZIP code		7 Bartering	8 Description	
Account number (see instructions)	2nd TIN not. <input type="checkbox"/>	9 Profit or (loss) realized in 2013 on closed contracts	10 Unrealized profit or (loss) on open contracts—12/31/2012	
CUSIP number		11 Unrealized profit or (loss) on open contracts—12/31/2013	12 Aggregate profit or (loss) on contracts	13 State
				14 State identification no.
				15 State tax withheld

Form 1099-B Cat. No. 14411V Department of the Treasury - Internal Revenue Service

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# Concerns with Form 1099-INT

- Definition of interest is not identical to definition of qualified stated interest (QSI) under OID regulations
- Temp reg. 1.6049-9T(b) will require reporting of amortized bond premium in 2 phases (2014/2016)
  - This will necessitate lot-by-lot rather than issue-by-issue reporting
- Will currently included market discount be reported on this form if election under Sec. 1278(b) is made?



# Changes to 1099-INT

## Current Form

9292  VOID  CORRECTED

PAYER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no.		Payer's RTN (optional)	OMB No. 1545-0112
<div style="background-color: yellow; padding: 5px; display: inline-block;">NEW</div> →		<div style="background-color: yellow; padding: 5px; display: inline-block;">1b bond premium amortization</div>	
		<div style="background-color: yellow; padding: 5px; display: inline-block;">1c market discount?</div>	
<div style="background-color: yellow; padding: 5px; display: inline-block;">POSSIBLE NEW</div>		<div style="background-color: yellow; padding: 5px; display: inline-block;">13 Interest Income</div>	
PAYER'S federal identification number		2 Early withdrawal penalty	
RECIPIENT'S name		3 Interest on U.S. Savings Bonds and Treas. obligations	
Street address (including apt. no.)		4 Federal income tax withheld	
City or town, province or state, country, and ZIP or foreign postal code		5 Investment expenses	
Account number (see instructions)		6 Foreign tax paid	
2nd TIN not <input type="checkbox"/>	10 Tax-exempt bond CUSIP no.		7 Foreign country or U.S. possession
		8 Tax-exempt interest	
		9 Specified private activity bond interest	
		11 State	
		12 State identification no.	
		13 State tax withheld	

Form **1099-INT** Cat. No. 14410K [www.irs.gov/form1099int](http://www.irs.gov/form1099int) Department of the Treasury - Internal Revenue Service

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CBL requires Bond Premium amortization reporting on 1099-INT.

- This is calculated from the cost basis data, not the legacy INT reporting systems.

1099-INT form may require reporting on market discount that is currently included.

# Concerns with Form 1099-OID

- Form does not currently require OID reporting for tax-exempt bonds
- Temp reg. 1.6049-9T(c) will require reporting of amortized acquisition premium in 2 phases (2014/2016)
  - This will necessitate lot-by-lot rather than issue-by-issue reporting
- Concerns about proper reporting of OID on stripped bonds (purchase price=issue price under Sec. 1286)

# Changes to 1099-OID

## Current Form

CBL requires Acquisition Premium reporting on 1099-OID

- This is calculated from the cost basis data, not the legacy OID reporting systems

9696		<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-0117	
PAYER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no.		1 Original issue discount for 2013		Form 1099-OID	
		1b acquisition premium			
PAYER'S federal identification number		2 Other periodic interest		13	
		3 Early withdrawal penalty		4 Federal income tax withheld	
RECIPIENT'S identification number		5 Foreign tax paid		6 Foreign country or U.S. possession	
RECIPIENT'S name		7 Description		File with Form 1096.	
Street address (including apt. no.)		8 Original issue discount on U.S. Treasury obligations			
City		ZIP or foreign postal code		8b tax exempt obligations?	
Account number (see instructions)		2nd TIN not.		9 Investment expenses	
10 State		11 State identification no.		12 State tax withheld	
		<input type="checkbox"/>		\$	
				\$	

Form 1099-OID Cat. No. 14421R www.irs.gov/form1099oid Department of the Treasury - Internal Revenue Service

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1099-OID form may require reporting on tax-exempt obligations (no OID de minimus)  
 Tax-exempt OID debt typically represents 50% of broker's debt holdings for clients

# Debt Transfer Reporting Data Requirements

- Customer/lot specific information
  - Purchase price
  - Acquisition date
  - Adjusted Issue price as of transfer date
  - Original Basis
  - Yield to Maturity (best/worse call)
  - Cumulative Acquisition Premium
  - Cumulative Amortized Bond Premium
  - Cumulative Accreted Market Discount
  - Adjusted basis
  - Adjusted Acquisition Date
- CUSIP specific information
  - Issue price
  - Issue date
  - Description of payment terms
- Customer elections (lot level)
  - Informing broker not to amortize bond premium
  - Constant yield election for market discount
  - Current inclusion election for market discount
  - All OID election/Constant yield election for acquisition premium
  - Last day of accrual/tax yr spot rate conversion election

# Option Transfer Reporting Data Requirements

## Sec. 1256 Options Excluded

- Customer/lot specific information
  - Amount of premium paid/rec'd
  - Acquisition/grant date
  - Adjusted basis
  - Adjusted Acquisition Date
- Option specific information
  - Any info required to fully describe the option such as:
    - Sec ID
    - Underlying
    - Quantity covered
    - Exercise type
    - Strike price
    - Maturity date

# Transfer Reporting Concerns

- Industry inconsistencies for transfer reporting prior to 2015
- GainsKeeper early work on debt transfers has identified challenges with the feasibility of accurately capturing all of the data attributes necessary for precise and consistent calculations across accounts
- Concerns for universal approach to options
- Timing and coordination of DTCC releases with GainsKeeper and Partner development
  - 2 CBRS releases planned in 2014
    - June, 2014
    - November, 2014
  - Requirements for June release expected in October, 2013

# Conclusion—As Challenging as Mt. Everest



# 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) are solely responsible for any tax, tax penalties or interest related to their tax returns
- GainsKeeper is a tool to assist taxpayers but does not cover a variety of specific tax rules or taxpayer circumstances and facts