FINANCIAL INFORMATION FORUM

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August 22, 2013

Electronic Delivery

Pamela Lew
CC:PA:LPD:PR (REG–102988–11)
Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station,
Washington, DC 20044

Re: Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options; Reporting for Premium [REG-102988-11]

Dear Ms. Lew,

The Financial Information Forum (FIF)[1] would like to take this opportunity to offer feedback and request guidance on the Final Regulations for Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options[2] (the "Final Regulations"). The FIF Cost Basis Working Group ("the Group") submitted several comments,[3] most recently in January of 2013, outlining critical issues for reporting of basis information for debt instruments and options, requesting that certain instruments be exempt from basis reporting and seeking additional time for implementation. We appreciate the exemptions the IRS agreed to in the Final Regulations as well as delaying the effective date for reporting on certain debt instruments and options. However, we believe there are aspects of the Final Regulations that require additional clarification before we can implement them successfully.

For those parts of the Final Regulations that become effective January 1, 2014, we have identified three requirements that we feel will either inflict hardship on taxpayers or place an undue burden on brokers and must be addressed immediately. For each of these requirements we request that you either consider the alternatives we will propose or provide penalty relief to brokers.

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[1] FIF (www.fif.com) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the financial technology industry across the order lifecycle. Our participants include trading and back office service bureaus, broker-dealers, market data vendors and exchanges. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

[2] T.D. 9616, 2013 USTR pp86, 155 (the Preamble).

[3] See FIF Comment Letters on REG–102988–11, dated January 27, 2012, February 23, 2012, October 17, 2012, and January 17, 2013

In addition to those three specific concerns, we have also included comments on one aspect of the requirements related transfer statements that we find completely unworkable in its current form. Fortunately, we believe that there is a simple remedy for this particular issue, so we have included it in this letter. With regard to the overall requirements for transfer statements and the application of holder elections to transferred securities, our members have many additional concerns. However, in as much as those requirements are not effective until January 1, 2015, we have decided to take some additional time to develop potential alternatives before addressing them to you. We appreciate your consideration of our comments. If you have any additional questions or concerns regarding these comments, we will be happy to arrange a meeting or conference call with our membership.

Support of Multiple Accrual Methods and Holder Elections

The Preamble to the Final Regulations states that "support for customer debt instrument elections would be beneficial to taxpayers and would not impose an undue burden on brokers"[4] though it also concedes that "the Treasury Department and the IRS do not anticipate that many taxpayers will make these elections."[5] We agree that few taxpayers will make any of these elections; however, we believe that actually supporting multiple accrual methods and building the necessary systems to support holder elections imposes a substantial new burden on brokers that was not even suggested in the Proposed Regulations[6]. The relative infrequency with which customers may elect out of one of the defaults does not reduce the complexity of implementing support of these elections in brokerage systems. Moreover, we are concerned that very little guidance has been provided with regard to the manner of elections, the application of elections to transferred securities, the revocation of elections or the interrelationships and dependencies between elections. We ask that you consider our comments and provide additional guidance regarding the issues that we have identified so that we can ensure that the Final Regulations are applied consistently by the financial services industry.

First, consistent with other cost basis rules, our members expect that they will generally support holder elections on an "account-by-account" basis. In the context of these elections, "account-by-account"

[4] Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options; Reporting of Premium, page 17.
[5] Preamble, p. 15.
[6] Proposed Regulations for Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options

means that a client making such an election would be asked to designate the account or accounts to which the election would apply and the broker will not apply that election to accounts not specifically designated. For example, if a client makes an election to currently include accrued market discount in income for an account held solely in the name of the client, the broker will apply that election to all bonds acquired at a market discount in that account during the taxable year that the election is effective and thereafter. If the client also holds a trust account with the broker, or even a second single name account titled identically to the account for which the election was made, the broker will not apply the election to currently include market discount in income for eligible debt instruments held in the second account absent an explicit instruction from the customer to do so. We believe this account-by-account approach is consistent with other cost basis rules as provided in Section 1012(c) and the regulations thereunder, as well as the basis adjustment provisions of the wash sale rules.

Second, the Final Regulations provide that an election to accrue market discount based on a constant yield and to treat all interest as OID are "generally made on an instrument-by-instrument basis."[7] However, it is unclear what an "instrument" is for purposes of the Final Regulations: a CUSIP (or other securities identifier), a tax lot, an individual note or other instrument? We believe that the customer expectations, administrability for the IRS and the industry, and the definition of "debt instrument" in Section 1275(a)(1) of the Internal Revenue Code support a conclusion that, for purposes of the Final Regulations, elections made on an "instrument–by-instrument basis" will be treated as made with respect to a single CUSIP (or other security identifier), rather than a tax lot or individual note.[8] We ask that the Final Regulations be clarified to confirm this understanding.

Third, with regard to those elections which must be made in a specific tax year in order to be applicable to a specific tax lot, brokers expect to ask the taxpayer to specify the tax year in which the election was originally made. This requirement is intended to provide the broker with more certainty as to which tax lots the taxpayer intends the election to be applied. For example, if a client were to open an account with a broker and transfer securities into that account from another brokerage account, the broker may receive tax lots acquired over many years. We recognize that transfer statements for each of these

[7] Treas. Reg. Sec. 1.6045-1(n)(4)(iii)-(iv).

[8] We observe that, as a general matter, customers do not hold more than one tax lot of a single debt security, and so would not expect to make different elections for different purchases of the same security. However, we acknowledge that a certain amount of manual processing would be required if a customer acquired different positions in a single security before and after an election was made; in such an event, manual processing would be required to ensure that election was not applied to the previously acquired instruments.

securities should provide information as to which elections the prior broker applied to specific tax lots. However, it is also possible that the transfer statement may provide information which conflicts with the elections provided (or not provided) by the taxpayer. We will address separately the resolution of conflicts between elections received from the client and election data transferred from a prior broker, however, in the interest of identifying and resolving any potential conflicts, we believe that it is prudent to request that the taxpayer provide the original tax year of the election with any election provided to the broker.

Finally, we believe that a broker should not be subject to penalty for inaccurate reporting when they rely on a written election provided by a client to alter their method of accrual or income reporting from the default requirement. This may seem like an obvious point, but these elections apply over multiple years and clients can change circumstances or brokers over that time. We foresee many scenarios where a client could notify a broker of an election and some years later chose a different method of accrual or income reporting and fail to notify the broker. Transfers can also become an issue, if the client fails to notify the new broker of an election or, alternatively, if the client revokes the election with the new broker and fails to notify the prior broker of the revocation. In all of these scenarios, we believe the broker should be allowed to rely on the elections that they have received (or not received) from the client as the determining factors for methods of accrual and income reporting.

Assumption of Election to Amortize Bond Premium, No Assumption for Accrual of Market Discount Using Constant Yield

With respect to the assumption to amortize bond premium, we support the decision to require brokers to apply this election by default. In most cases, this election clearly results in a favorable treatment of income and expense for the taxpayer. Requiring the taxpayer to provide an affirmative statement to the broker to elect this treatment will disadvantage taxpayers not familiar with this rule and create unnecessary client service issues for brokers.

We are surprised that, in light of the IRS approach to the election to amortize bond premium, the IRS did not choose to require brokers to make a similar assumption with respect to the accrual of market discount using constant yield. That method is also clearly advantageous to the taxpayer although net impact on income recognized annually is not as substantial. Brokers who calculate and report accrued market discount to clients on a voluntary basis typically calculate the accrued market discount using

constant yield. Explaining the differences in these calculations to clients who are not mathematically inclined and obtaining the necessary election from clients who decide to use constant yield going forward is going to be a substantial administrative burden for brokers. In light of the tax benefit of this election to clients, we would prefer that this election also be assumed.

Revocations of Elections

The holder's right to revoke an election also adds complexity to supporting these elections. Of the five elections that brokers are required to support under the Final Regulations, four are revocable "with the consent of the Commissioner."[9] Where a customer has revoked or will revoke an election, the Final Regulations require the customer to notify the broker of that revocation and the broker is required to report information consistently with that revoked election.[10] We appreciate that if brokers are required to support elections, we must also support revocations of those elections; however, we are concerned that brokers could be held liable for inaccurate reporting penalties as a consequence of a notice received from a customer if the customer has not, in fact, secured the permission of the Commissioner to revoke an election. Moreover, because the Final Regulations require a broker to change its reporting not only upon notice that a customer *has* revoked an election, but also if it *will* revoke an election, firms will, by, necessity have to rely on the information provided by the customer since the revocation would not actually be in place at the time the notice is made. Consequently, we believe that brokers should be entitled to rely on customer notices regarding revocations without risk of reporting penalties.

Revocation of certain elections presents other potential conflicts. The election under 1.1272-3 to report all income as OID effectively applies the constant yield method to the calculation of all income and expense amounts for the tax lot including both Market Discount and Acquisition Premium, which are by default calculated using the ratable method. This election is revocable under 1.1272 – 3; however, once accruals have been calculated using the constant yield method, the method of accrual cannot be switched back to the ratable method and produce an accurate result for either market discount or acquisition premium. With respect to the accrual of market discount, this issue was clearly identified and addressed in 1.1272-3. The statute specifically states that a holder that makes this election is

[9] Final Regulations pages 66 – 67. Elections to accrue bond premium, to currently include market discount, to treat all interest as OID and to translate interest income and expense at the spot rate are all revocable with the consent of the Commissioner. See Treas. Reg. Sec. 1.6045-1(n)(4)(i), -(ii), -(iv), and –(iv). The election to accrue market discount based on a constant yield may not be revoked. See Treas. Reg. Sec. 1.6045-1(n)(4)(iii).
[10] Treas. Reg. Sec. 1.6045-1(n)(5).

"deemed to have made both the election under section 1276(b)(2) for that instrument and the election under section 1278(b) for the taxable year in which the instrument was acquired."[11] As noted in the Final Regulations, the election under 1276(b)(2) to use constant yield to accrue market discount is not revocable. Therefore, the holder may revoke the election under 1.1272-3; however, doing so does not revoke the "deemed" election under 1276(b)(2). This election is not revocable because changing the method of accrual after income has been calculated and realized will result in an inaccurate accrual calculation that will not balance to the redemption value of the security unless the yield is re-calculated.

Yet there is no similar provision for the calculation of acquisition premium using constant yield. The Final Regulations do address the requirement to use the constant yield method to amortize acquisition premium when the customer makes the election under 1.1272-3[12], but they do not address what happens to the accrual of acquisition premium when the holder revokes this election. We believe that the revocation should result in the reporting of OID reduced by the amount of accrued acquisition premium; however, the method of accrual applied to acquisition premium should remain constant yield after the revocation. To revert to using the ratable method when the election under 1.1272-3 is revoked would produce accrual amounts of acquisition premium that would not be the same over the remaining life of the bond as they would have been if the ratable method had been used from the inception of the tax lot. It is possible to force the ratable accrual calculation to balance to the redemption value at the point in time when the revocation becomes effective; however, this methodology just adds more complexity to calculating accruals for both brokers and taxpayers, particularly if one has to re-construct the calculations done over a number of years. We believe that supporting the election will be more manageable for all parties involved if accruals of acquisition premium are calculated using constant yield method after a revocation of an election under 1.1272-3.

Wash Sales

In section 1.6045-1 (6)(B)(iii), the Final Regulations add a statement that on transfer statements, "in general, the broker must increase the basis of the purchased security by the amount of loss disallowed on the sale transaction." Among our members, there is some disagreement as to whether wash sale adjustment amounts for debt securities should be provided on transfer statements as part of the adjusted basis or as a separate value. The argument in this case stems from the fact that the receiving

[11] 1.1272-3 (b)(ii)(B)
[12] Final Regulations pages 71-72

broker must continue to calculate accruals for the debt instrument. For a tax lot acquired at a premium, if basis is adjusted for a disallowed loss, the amount of that loss will be amortized and will reduce current taxable interest income. This does not seem to be the correct treatment of a capital loss. Rather, it is suggested that the original basis adjusted for accruals should be transferred not adjusted for wash sales. The wash sale adjustment amount and holding period adjustment should be transferred as separate values. In this way, the receiving broker can carry forward the accrual calculations and apply the wash sale adjustment when the lot is ultimately closed. We ask that this uncertainty be clarified to ensure consistent reporting within the industry.

Compensatory Options

Brokers began reporting cost basis for equities acquired on or after January 1, 2011. Under the Final Regulations issued in 2010, brokers were permitted, but not required, to increase the initial basis for income recognized upon the exercise of a compensatory option or the vesting or exercise of other equity-based arrangements, granted on or acquired before January 1, 2013. Many brokers have followed this guidance and for the last two years have been reporting the basis of shares acquired through the exercise of a compensatory option adjusted for the income component of the option on the 1099-B.

The Proposed Basis Reporting Regulations for Options issued in 2011 would have allowed brokers to continue the practice of reporting the income component of the award but also explored the possibility of including an indicator on the 1099-B and a corresponding indicator on the transfer statement that would identify shares acquired through the exercise of a compensatory option, as well as whether the basis of those shares had been adjusted for income reported by the employer on the employee's W-2. Under the Final Regulations issued in 2013, the IRS agreed not to add the transfer indicator for compensatory options in response to industry comments and also went a step further and prohibited brokers from adjusting the basis of shares acquired through the exercise of a compensatory option for the income component of such options granted on or acquired after January 1, 2014. The stated intent of this change in the basis reporting rules for shares acquired through the exercise of compensatory options is to "eliminate confusion and uncertainty for an employee who exercised a compensatory option."[13]

[13] Preamble to the Final Regulations for Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options, p.30.

We believe this approach will significantly increase client confusion. Clients who have been receiving the correct adjusted basis will now have to account for the income component adjustment themselves on their Form 8949. If this step is missed, the clients will incur tax from income reported on their Form W-2 and the capital gains tax from gains calculated from the Form 1099-B. This will eventually lead to frustration and complaints. It is also standard practice for brokers to provide clients with a summary view of their gains and losses in supplemental reporting. This additional documentation enables clients to easily determine total short and long term gains and losses in a given account and can be used in tax filing preparation. If the basis adjustment is not made for the income component of compensatory options, the client's cost basis will be understated in summary reporting rendering this reporting unreliable. This will require the client to spend more time making manual adjustments. While brokers would have the ability to display both the adjusted and unadjusted basis values in supplemental reporting, it is infeasible in most accounting systems to maintain two versions of the basis. Given the overall direction of basis reporting requirements is to align broker reporting with taxpayer reporting, not including the income component in basis represents a departure from this approach which will create client service issues.

As an alternative, we recommend the following approach to compensatory options. First, the IRS should continue to allow brokers to adjust the basis of shares acquired through the exercise of compensatory options permissively. This approach will allow brokers who support compensatory options business and receive the information necessary from the employer to make the proper adjustment to continue to provide accurate adjusted basis to their clients and to the IRS. Second, for brokers who choose to do business in this way, the new 1099-B indicator should be added to allow the broker to provide a clear indication to the client and the IRS that basis has been adjusted. Those brokers who do not support compensatory options business or choose not to adjust basis in this scenario will not populate this new indicator on the 1099-B. This approach again provides a clear statement that basis has not been adjusted to both the taxpayer and the IRS. Finally, in the event that a taxpayer chooses to transfer shares away from broker who originally executed the exercise of the compensatory option, the delivering broker will provide unadjusted basis only on the transfer letter for the shares. This approach will relieve the receiving broker from having to evaluate a transfer indicator, report adjusted basis or populate the new indicator on the 1099-B. In this scenario, the taxpayer would have to calculate adjusted basis and file Form 8969. Although this approach places the additional burden of adjusting

basis on the taxpayer who has chosen to transfer shares acquired through the exercise of a compensatory option, such instances are relatively rare, and we feel that this approach provides the certainty that the IRS indicated was necessary in this situation without adding complexity to the transfer process.

Overall, we view this approach to reporting adjusted basis on shares acquired through the exercise of a compensatory option permissively to be similar to the rules permitting, but not requiring, brokers to make basis adjustments to stock rights and warrants under Sections 305 and 307 depending on their capabilities. The fact in the case of compensatory options is that the number of transfers that would require this new transfer indicator is miniscule by comparison to the hundreds of thousands of equity transfers settled by brokers every day. To create a new indicator that would be used so rarely is inefficient and adds yet another unique feature to an already complex process. We believe that our clients will be best served by allowing brokers that engage in compensatory option business to adjust basis whenever possible, but not requiring brokers that do not support this business to support a transfer indicator for the relatively few instances where a taxpayer chooses to exercise a compensatory option, hold the shares and subsequently transfer the shares to another broker.

Transfer of Basis for 1256 Options

In Section 1.6045A-1 (a)(1)(vi), the Final Regulations state that "[a] transferor of an option described in 1.6045 1(m)(3) is not required to furnish a transfer statement." Section 1.6045 1(m)(3) is the section describing the reporting requirement for options covered under Section 1256. These requirements include treating the options as regulated futures and reporting them on Form 1099-B according to the requirements of paragraph (c)(5) of the same section. We are not clear on how we can fulfill those requirements without a transfer statement.

When a 1256(b)(1)(A) regulated futures contract is "transferred" from one broker to another, the contract is, in actuality, closed by the "delivering" broker and a new replacement contract is opened by the "receiving" broker with the proceeds of the terminated contract. Closing the contract is a taxable event causing the recognition of gain or loss, and the customer would receive a 1099 from the "delivering" broker reflecting that recognized gain or loss. The new position opened at the "receiving" broker would have a basis equal to its fair market value. Under these circumstances, we agree with the Final Regulations that no transfer statement is necessary.

However, this is not the case for a 1256 option; notwithstanding the statement in 1.6045-1(m)(3) that such options should be treated as if they were regulated futures contracts, the options are actually transferred between brokers and the transfer is not a recognition event. If the security was transferred and no transfer statement was provided, the receiving broker would not know the original cost and would thus not be in a position to report gain/loss at the year-end mark or earlier sale/termination.

We believe this should be addressed in a correction to the Final Regulations. At this time, we are recommending to our members to provide a transfer statement for 1256 options as a best practice; however, we would like the IRS to provide some clarification on this issue.

Transfer Statements

Our members have numerous concerns with respect to the requirements for transfer statements included in the Final Regulations. We have addressed a few of these concerns in this letter, but we have other concerns which we continue to discuss. In as much as the requirements relative to transfer statements are not effective until January 1, 2015, we felt it was important to present our concerns regarding those requirements that become effective in 2014 immediately so that you have an opportunity to review and provide guidance. We intend to draft a subsequent letter to address our additional concerns regarding transfer statements.

The members of the FIF Cost Basis Working Group are working hard towards the successful implementation of this important project and look forward to clarification on the IRS's intent with respect to the sections of the Final Regulations mentioned above. Please do not hesitate to contact me at fifinfo@fif.com or 212-422-8568 with any questions.

Regards,

Thair Joshua

Program Director, Financial Information Forum

On behalf of the FIF Cost Basis Working Group