FINANCIAL INFORMATION FORUM

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Pamela Lew
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Re: Section 403 of the Emergency Economic Stabilization Act of 2008 (H.R. 1424)
Fixed Income Basis Reporting

Dear Ms. Lew,

We would like to thank you for meeting with our group at the end of September to discuss the results of the FIF Cost Basis Survey on Fixed Income. In light of the survey results and subsequent discussions of our working group, the Financial Information Forum (FIF) [1] would like to take this opportunity to raise concerns regarding the assumed implementation date for fixed income cost basis reporting. With proposed regulations not yet available for comment, the FIF Cost Basis Working Group is extremely concerned about the adequacy of the next thirteen months to meet the assumed January 1, 2013 fixed income cost basis effective date. We respectfully request:

- Moving the effective date of fixed income basis reporting to a minimum of 18 months after issuance of final guidance. The IRS has the authority to do this under the statute and it would allow participants to comprehensively analyze, develop, test, deploy and communicate the changes required to accurately provide cost basis information for fixed income securities.
- Meetings with the IRS and relevant stakeholders to open a dialogue regarding the many implementation challenges. By discussing the industry's concerns in more detail, the IRS will have the benefit of understanding the guidance FIF members need to smoothly implement the requirements for fixed income cost basis reporting.

In the third quarter of 2011, the FIF Cost Basis Working Group surveyed firm practices related to basis adjustments on fixed income securities. The study covered the firms' capabilities in calculating adjusted cost basis, particularly amortization and accretion methods, to determine similarities and differences among firms and to identify specific areas that require clarification and definition in preparation for 2013. The results[2] of this "Fixed Income Survey" showed great disparity in the firms' current practices, both generally as to whether basis adjustment calculations are applied to all fixed income instruments, and specifically in the way certain types of instruments or bond characteristics are handled. Since there has been no regulatory requirement to date for firms to track cost basis on fixed income securities and

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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] See FIF Cost Basis Fixed Income Survey – Final Report

no established industry standard, the survey found some firms to have provided a level of support they were comfortable with merely as an accommodation to clients.

These results clearly demonstrate the need for timely, specific guidance. FIF members are concerned that their current level of support for fixed income cost basis adjustments may fall far short of what the regulations will require. The firms that do offer some level of support for fixed income basis tracking and adjustments are using differing methods and approaches in providing such information, particularly depending on the security type and terms and conditions of the instruments. In many instances, firms are not providing accommodation basis tracking at all, particularly when such tracking and calculations would involve complexities beyond merely recording acquisition cost. Most firms will need to make significant changes to their current systems in order to provide even a basic level of cost basis reporting for fixed income securities. FIF members would face even greater challenges if basis reporting requirements are designed to incorporate the complex substantive rules that govern taxpayers' gain and loss calculations for fixed income securities.

The majority of respondents that participated in a study conducted previously by the FIF Cost Basis Working Group (see the FIF Cost Basis Survey III report published in January 2011) indicated that 12 – 18 months would be required after issuance of guidance from the IRS in the form of published regulations on fixed income. Now that the industry has begun to examine the requirements of tracking cost basis on the broad spectrum of fixed income securities more deeply, FIF members believe these estimates were overly optimistic and that a minimum of 18 months is needed. Furthermore, FIF members are concerned that there may be a general misperception that the foundational cost basis systems implemented to meet Phase 1 compliance requirements in 2011 are sufficient for fixed income and other basis tracking. The survey results clearly demonstrate that this is not the case; the complexities to be faced for fixed income are far more substantial than those considered when building the systems to handle equities.

In preparing for equity cost basis reporting, the IRS and Treasury personnel met with stakeholders to gain an understanding of issues facing the industry. FIF believes similar meetings are critical at this juncture, particularly in light of the short time frame remaining for the implementation date for fixed income basis reporting. The tracking and transferring of basis for fixed income securities is far more complex than equities. FIF believes a series of topical meetings with the IRS covering specific fixed income security types would assist the IRS in understanding and considering the issues facing the industry. It is critical for the industry to have a clear definition of adjusted cost for fixed income. Examples of topics to be discussed include:

- Challenges in complying with the "worst call" amortization rule.
- Calculating amortization for certain security types such as asset backed securities and variable rate/ variable payment schedules.
- Incorporating client preferences in calculating amortization

Without a clear definition of adjusted basis, it is not reasonable to expect the industry to maintain and report anything other than original basis by January 2013. We ask that the IRS consider these and other fixed income complexities facing the industry in light of the lead time needed for software development as it drafts the regulations and establishes the timing for implementation.

As a means of demonstrating the various challenges facing our industry, we have included some questions that FIF members have raised during our most recent survey as an appendix to this letter. After reviewing this sampling of issues we are hopeful that the IRS will appreciate why we require additional time as well as further clarification and guidance before undertaking massive efforts to develop systems that meet requirements for yet to be defined cost basis reporting regulations. It is important to note that in addition to the fixed income and options[3] requirements for 2013, the industry continues to devote considerable resources to ensure on-going compliance with the 2011/2012 requirements.

In closing, we would like to re-iterate our request for a minimum of 18 months from the issuance of final guidance to complete the necessary system changes for fixed income basis reporting. Given the significant challenges in accurately adjusting fixed income basis, there is no doubt that an open and active line of communication with the IRS will be beneficial to both the Industry and the IRS in achieving their shared goals of accurate and timely basis reporting for fixed income and other complex instruments.

Regards,

Arsalan Shahid
Program Director, Financial Information Forum
On behalf of FIF Cost Basis Working Group

CC: Catherine Barre, Office of Deputy Commissioner for Services and Enforcement
Alice Bennett, Branch Chief, Office of Associate Chief Counsel, U.S. Department of the Treasury
William Blanchard, Senior Technician Reviewer, U.S. Department of the Treasury
Michael Novey, Associate Tax Legislative Counsel (Tax Policy), U.S. Department of the Treasury
Karl T. Walli, Senior Counsel (Financial Products), U.S. Department of the Treasury

[3] While fixed income is the focus of this letter, our members are also concerned about the new options requirements for 2013. Our group is currently considering the scope and magnitude of options basis reporting issues.

Appendix I - Fixed Income Topics - Questions for IRS

- **Structured Products[4]:** Please refer to 'IRPAC Follow-up Comments as of June 23, 2009', specifically regarding Investment Units and Reverse Convertibles listed under topic number 17. Firm feels that FIF should recommend that IRS delay implementation of basis reporting on these hybrid types of securities beyond 2013, until such time as IRS issues further guidance on standardized methodology for industry to follow regarding the proper tracking of cost basis.
- **Treasury Inflation Protected Securities (TIPS):** These issues require special handling by cost basis engines; need industry standardization. There are concerns around Consumer Price Index (CPI) number versus actual index ratio and subsequent impact on market valuation.
- **Municipal and corporate bonds that become 'factorable' after historically paying straight coupon interest at par:** Recent history has shown a number of municipal and corporate issues that had traditionally paid out actual coupon, for example, over the last ten to fifteen years. Then, their amended prospectus reports that the issuer will start paying down principal on a regular basis, thus becoming 'factorable' mid-stream. There are concerns involved surrounding issues such as identification, firm/vendor classification, factor data and basis repercussions.
- **IRS extension of fixed income regulations beyond 2013:** Given the amount of work that will go into compliance with tracking and reporting of option securities, and that the final regulations did not specify a hard deadline for fixed income reporting, what possibility is there that fixed income reporting could be extended past 2013?
- Does the issuance of a bond or note require an Issuer Return under IRC 6045B in order to know the correct issue price, call provisions, conversion terms, etc.? What about reorganizations resulting from bankruptcy proceedings when new bonds or notes are issued for old bonds and notes?
- Will debt obligations reportable under other rules – such as REMICs – require cost basis adjustments? If so, what about the impact of data lags under IRC §1272(a)(6) when a taxpayer transfers a REMIC security to another account or person?
- Will any special reporting be required for return of principal payments when there is accrued market discount that must be recognized first?
- What reporting will be required, if any, for the conversion of convertible bonds or preferred stock?
- Will there be a requirement to adjust basis for OID accruals on a daily basis, consistent with the statutes and regulations? (NOTE: OID accruals are based on daily accruals, but most brokers capture OID information only on an annual basis after year end. Not doing it on a daily basis would impact the information provided on transfer statements during the year.)
- Tax exempt bonds. The OID is not reportable on the Form 1099-OID, and many brokers do not provide it as supplementary information. Also, there is no de minimus OID on a tax-exempt bond. Currently, most brokers do not capture or report this information.
- What about OID accruals and deflation adjustments for publicly traded debt securities? Will Treasury be required to provide that information on a daily basis to ensure accurate transfer statement information?

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[4] Examples of structured products include: index-linked notes, equity-linked term notes, trust preferred, fixed rate capital securities, income deposit securities, mandatory convertible securities, reverse convertible securities, QUIBs (Quarterly Interest Bonds), QUICS (Quarterly Income Capital Securities), QUIDS (Quarterly Income Debt Securities), QUIPS (Quarterly Income Preferred Securities), etc.

- Will certificated bonds be exempt from the definition of a "covered security" since the broker or trustee seldom knows what money was exchanged, whether or not it was exchanged as a gift, etc.?
- What reporting will be required for contingent payment debt instruments where the gain or loss generally cannot be treated by the taxpayer as a capital gain or loss? Will the broker be required to identify that, or will that be a taxpayer adjustment situation on the Form 8949?
- Will all existing election methods still be utilized for "covered" fixed income basis reporting? Market discount accrual at time of sale or over the entire holding period of bond?
- Will the IRS require changes to 1099-OID and/or 1099-INT to report offset of premium amortization, market discount accrual taxable income)?
- Will straight line and constant yield methods continue to be elections available to client?
- Will clients be able to elect whether accretion and amortization are calculated based on yield to next call, yield to maturity or yield to worst call?
- Will clients continue to have the election available to recognize losses at the time principal payments received or at disposition?
- Does Amortization and Accretion election need to be made in writing?
- Will it be a requirement to pass the yield used for amortization and accretion on transfer statements?
- What reporting will be required on defaulted bond and builder bonds?
- What special reporting must be completed for perpetual maturity, remarketed, territorial and foreign bonds?
- What method should be utilized to determine an equivalent fixed rate instrument when determining premium on variable rate debt instrument?
- Will clients be able to make elections to amortize on a security or account level? Does revocation need to be supported?
- Will the IRS require changes to 1099-B?