FINANCIAL INFORMATION FORUM

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October 17, 2012

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

Dear Pamela,

On behalf of the FIF Cost Basis WG, please see an update to our September 12, 2012 letter below containing the following changes:

1. Removal of the word “Putable” from Section 3 of the letter on page 8. FIF members believe Putable bonds are extremely rare and will not be addressed at this time.

Regards,

Arsalan Shahid

Program Director, Financial Information Forum

On behalf of FIF Cost Basis Working Group

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Electronic Delivery and FedEx

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P.O. Box 7604, Ben Franklin Station,
Washington, DC 20044

Re: Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options [REG-102988-11] REVISED: October 17, 2012

Dear Ms. Lew,

The Financial Information Forum (FIF) [1] would like to offer recommendations for basis reporting by securities brokers and basis determination for debt instruments. The FIF Cost Basis Working Group submitted comments earlier this year[2] outlining critical issues and requested additional time for implementation. FIF appreciates the IRS delaying the effective date on reporting for debt instruments and options by brokers from January 1, 2013 to January 1, 2014[3] and providing feedback to industry recommendations as we work toward meeting the January 1, 2014 deadline.

The FIF Cost Basis WG is providing recommendations below which we believe will facilitate industry implementation of these new requirements and requests the IRS to consider these when drafting the Final Regulations. Our recommendations fall into four major sections:

1. Carve out debt instruments with specific characteristics that add substantial complexity to the calculation of adjusted basis.
2. Modify 1099-B reporting requirement of accrued market discount for OID bonds.

[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 Comment Letters on REG–102988–11, dated January 27, 2012 and February 23, 2012
[3] See IRS Delays Debt and Options Reporting to January 1, 2014

3. Confirm standard calculation of Adjusted Basis for Bonds with Issuer or Holder Options.

4. Require brokers to provide original basis adjusted only for wash sales for debt securities at the time of transfer.

Section 1: Carve-outs

FIF has identified several characteristics of fixed income instruments that add substantial complexity to the calculation of adjusted basis. We believe that carving out these instrument types will allow brokers to focus on the challenges of implementing systems that will calculate, transfer and report adjusted basis for the preponderance of fixed income instruments that do not have these extra complexities. Together, we believe that the instrument types we are requesting to have carved out represent a very small percentage of the securities that would be covered under the proposed regulations[4].

Variable Rate Securities: FIF proposes that the IRS carve out qualified and non-qualified variable rate debt under Section 1.1275-5, including floating rates, step rates, ELKS and convertible fixed income instruments from securities covered in 2014. The data processing burden for these instruments is significantly greater than for fixed rate securities because the amortization / accretion factors and schedule must be re-calculated for each rate change and historical rates must be maintained to support correction processing. Brokers typically capture only the current rate and do not accumulate and retain historical rate data. Nor do brokers or data vendors currently review new issues in sufficient detail to determine if the issue is a “qualified variable rate” under section 1.1275-5.

It’s worth noting as well that variable rate securities by their nature tend to not trade at significant premiums or discounts to the market. The initial interest rate for a variable rate security is generally set according to market rates and the credit quality of the issuer. Thereafter, their rates reset according to some widely recognized market index that adjusts to interest to current market rates. Therefore variable rate securities in general do not trade at a significant premium or discount to par unless there was a substantial change in the issuer’s credit rating or there was a sharp change in the interest rate environment. Although this can happen, it is relatively rare and would only affect transactions done

[4] Based on statistics published by SIFMA. As of the end 2011, the Total Outstanding US Bond Market was $36,756 trillion. We have excluded Mortgage Related and Asset Backed securities as these bonds are generally factored and therefore not covered by the Proposed Regulations. This exclusion reduces the overall total value of securities that would be covered under the Proposed Regulations to $26.492 trillion. Annual Issuance statistics from 1996 - 2011 suggest that variable or floating rate bonds represent $2.885 trillion or 10.8% of the Total Outstanding US Bond Market, however a survey of committee members indicates that the current percentage of variable rate securities held on their books is much lower. Each of the other categories of securities we are requesting to be carved out represent less than 1% of the US Bond Market.

during the reset period in which the change occurred. We therefore believe that this class of securities does not represent a significant amount of the reportable Market Discount that is the objective of the Proposed Regulations.

Principal Adjusted Securities: Principal adjusted bonds are instruments with features that can result in changes to the holder's principal. The most common of this class of securities are TIPS (Treasury Inflation Protected Securities) issued by the US Treasury, which have a feature that adjusts the principal amount of a bond annually based on changes in the CPI**.** Payment-in-Kind (PIK) instruments have a different feature that produces a similar result. With a PIK bond, the issuer is allowed to make interest payments in additional principal in the security. TIP and PIK bonds both require that the amortization / accretion schedule be recalculated at each payment because of the changes in the valuation of both the principal and future income after each income payment. FIF requests that principal adjusted instruments like TIPs and PIKs also be carved out of securities to be covered in 2014.

Non-USD Bonds: FIF proposes carving out non USD bonds due to complexity in recalculating accruals at the end of each accrual period to apply current exchange rates. We do not have a reliable number for the value on Non-USD denominated fixed income securities held for US investors, but anecdotally, a review by our members indicates this number is very small. According to Treasury Department Reports[5], the annual net purchases of long term foreign bonds by US investors appears to be just over $100 billion annually, which is less than 1% of the total US bond market.

Tax-Credit Municipal Bonds: In recent years, municipal issuers have had the option to issue bonds that provide the holder with a tax credit, generally allowable on a quarterly basis, against federal income tax.[6] Eligible bonds include Qualified Zone Academy Bonds, Clean Renewable Energy Bonds and new Clean Renewable Energy Bonds, Qualified Energy Conservation Bonds, Qualified School Construction Bonds, and Recovery Zone Bonds. The credit amount is generally treated as interest included in the holder's taxable income (see section 54A (f)). In some cases the credit rate is intended to constitute the entire interest yield on the bonds; in others the bondholder receives both a tax credit and coupon interest. These bonds represent only a tiny portion of the total issuances of debt. For example, issuances

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[5] Source: Treasury International Capital Reporting System

[6] More recently, the law has also provided an option for the municipal issuer to obtain a refund of a portion of the interest it pays on certain specified types of bonds (Build American Bonds, Qualified School Construction Bonds, New Clean Renewable Energy Bonds, Qualified Energy Construction Bonds, and Qualified Academy Zone Bonds). See section 6431. These bonds are simply coupon paying taxable bonds and can be treated the same way as taxable bonds issued by corporations.

of tax-credit bonds in 2009 accounted for 0.7% of total municipal bond issuances (tax-exempt and taxable).[7] While it seems clear that both the credit rate and any coupon interest should be treated as interest for purposes of computing yield on these bonds, data regarding the amount of the tax credit applicable to the holder for each of these kinds of issues is not generally captured and distributed today. We would like to see tax credit bonds carved out of securities to be covered in 2014 and specific guidance on the calculation of yield for these instruments issued before they become covered.

Contingent Payment Debt Securities: Contingent payment securities are debt instruments where interest payments may vary based on contingencies such as the value of a particular index or the trading price of a particular security during a particular time period. Calculating adjusted basis for this type of security involves projected contingent payments (interest), non-contingent payments (principal payments) and possible carry forwards from prior years. These requirements present similar challenges as factored securities and variable rate securities plus the unique challenge of loss carry forwards.[8] Due to these complexities, FIF requests that contingent payment debt also be carved out of debt securities covered in 2014. We should also note that contingent payment debt securities are already carved out of the premium regulation (See 1.171-1(b)(2)(ii)). Although we do not have reliable measurement of size of this carve out, we believe it to be extremely small (less than 1/10 of 1% of the overall US Bond Market). We have included links to prospectuses of two examples of contingent payment securities for your review[9].

Factored Bonds– Lastly, FIF requests that the IRS clarify the definition of factored bonds that are to be carved out of the Final Regulations. The Proposed Regulations define debt instruments described in section 1272(a) (6) (debt instruments with principal subject to acceleration) that are acquired on or after January 1, 2013, as not a covered security. The definition in Section 1272(a) (6) (C) includes:

- (ii) any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument (or, to the extent provided in regulations, by reason of other events)

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[7] IRS, Statistics of Income, SOI Data on Municipal Bonds, http://www.irs.gov/pub/irs-soi/09ebsnap.pdf
[8] See S 1275-4(b)
[9] http://www.sec.gov/Archives/edgar/data/83246/000114420410040311/v191941_424b2.htm and http://www.sec.gov/Archives/edgar/data/32258/000095013605007907/file001.htm

- (iii) any pool of debt instruments the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).

Together these two paragraphs appear to cover many of the securities that brokers refer to as "factored bonds," which are bonds that repay principal on a schedule defined in the prospectus over the life of the instrument without redeeming bonds held by any particular holder, as would be the case with a partial call. Upon each payment, the principal value of each bond in the issue is reduced from its original face value. At any point in time, a "factor" is necessary to determine the remaining percentage of original principal.

Factored bonds backed by mortgages on real estate are the most common example of a factored bond and clearly fit into the definition in paragraph (ii). However, we are uncertain whether factored bonds backed by other kinds of receivables such as credit card debt, equipment leases or physical assets, fit into the definition in either paragraph (ii) or paragraph (iii). Please review the example of a bond secured by aircrafts[10]. The prospectus includes a principal repayment schedule that returns principal to bond holders on a defined schedule in advance of the redemption or maturity of bond. We would also define this bond as factored and recommend that it be non-covered for 2014. If the IRS considers it to be covered under the definition in 1272(a) (6), then the exclusion already in the Proposed Regulations is sufficient to exclude factored bonds as we understand them.

If the Service is not amenable to carving out any of the above security types then as a possible alternative the FIF Cost Basis WG would propose modifying the requirements for these security types to require the reporting of original basis only.

Section 2: Reporting Accrued Income or Expense on the 1099-B

The Proposed Regulations include the following requirement "a broker also must report the amount of Market Discount that has accrued on the debt instrument as of the date of sale[11]". FIF members see significant implementation challenges in attempting to report a separate Market Discount amount for OID bonds and propose an alternative to report a single amount (Accrued Discount / Premium) on the 1099-B that represents the net of all accrued income or expense.

As we noted in our original comment letter and in our comments at the public hearing, many brokers use outside vendors to perform OID calculations and only do so at year end as part of the process of producing annual 1099 OID reporting. This OID reporting process is not integrated with the broker's cost

[10] http://www.sec.gov/Archives/edgar/data/4515/000095012309061147/d69961sv1za.htm#104
[11] Proposed Regulations

basis accounting system, so the annual OID amounts are not captured and applied to tax lots. To integrate these processes would be a substantial effort and will introduce risks to both the 1099 reporting and cost basis accounting processes.

For non-OID instruments, under FIF's proposal to report a single amount on the 1099-B, the accrued income or expense will be easily distinguishable to both the Service and the taxpayer. If it is preferable to only report income on the 1099-B, we can easily exclude accrued bond premium and report only accrued Market Discount. With this information, both the Service and the taxpayer should be able to easily determine the amount of reportable accrued Market Discount and, after reviewing amounts reported in prior years, determine the reportable amount for the current year. Our analysis indicates that over 90% of fixed income instruments that will be covered under the Proposed Regulations are non-OID instruments[12], so we believe that this method of reporting will provide clear and actionable information for both taxpayers and the Service for the vast majority of reportable instruments.

For OID instruments, we propose to report a single amount that represents a net amount of two types of income. A bond that is subject to OID reporting could have both OID and Market Discount or Bond Premium and Market Discount or other combinations of original issue and market premiums or discounts. We believe that when combined with the annual OID amounts that brokers have already reported to taxpayers and to the Service, it will provide both parties with sufficient information to determine if there is accrued Market Discount that is reportable as income either in prior years or in the current year.

The amount we propose to report is income that should have been reported in prior years as well as the current year. If the amount of OID reported in prior years and the current year equals or exceeds the amount reported on the 1099-B, then there is no accrued Market Discount and no income to be reported. If not, then the difference between OID reported in prior years and the current and the amount reported on the 1099-B is income that is reportable in prior years and / or the current year.

The Proposed Regulations not only call for brokers to track income over multiple years, but also to transfer this information between brokers until the instrument is sold or redeemed. This scenario results in Broker A ultimately reporting to the client and the Service on a 1099-B an amount of OID income that was originally reported to the client and the service by Broker B and potentially brokers C, D and E, etc.

[12] Analysis by individual broker dealers on our committee indicates that OID instruments represent approximately 5.6% of unique Taxable bond issues and 2.9% of non-taxable bonds.

Brokers do not track income like this over multiple years and we believe that ultimately both taxpayer and the Service receive annual reporting of OID and should perform the reconciliation necessary to account for both OID and accrued Market Discount over the life of the instrument when it is sold or redeemed. Asking brokers to transfer accumulated OID reported over multiple years potentially by multiple brokers and then report cumulative amounts when the instrument is eventually sold or redeemed simply introduces another variable into the reconciliation and creates more opportunity for error. If this solution is not acceptable to the Service, then FIF requests that OID instruments be carved out of securities covered in 2014 so that a better alternative can be found.

Section 3: Calculation of Adjusted Basis for Bonds with Issuer or Holder Options

Under the existing regulations, the yield that is required to be used for calculating adjusted basis for fixed income securities are defined in terms of whether the security was acquired at a premium or at a discount and then, within each of those sections[13], whether the interest paid on the security is taxable (included in gross income or not). However, after reviewing all the rules related to issuer and holder options in each of these sections of the Code, the FIF Cost Basis WG has concluded that all of the possible outcomes result in two simple rules as follows:

- **Fixed Rate, Callable and Taxable** – Adjusted basis for fixed rate bonds with issuer or holder options (Callable) that pay taxable interest will be calculated using constant yield method and Yield To Maturity (YTM).

- **Fixed Rate, Callable and Non-Taxable** – Adjusted basis for bonds with issuer or holder options (Callable) that pay non-taxable interest will be calculated using the constant yield method to the call date or maturity date that minimizes the holder's yield. This method is referred to in the brokerage industry as "Yield to Worst" (YTW).

The FIF Cost Basis Working Group recommends that the IRS include a statement to this effect in the Final Regulations for the benefit of brokers, taxpayers and tax preparers. Such a statement could alleviate some confusion and frustration for each of the constituencies. Based on issuance statistics from 1996 – 2011[14], we estimate this category of bonds represents more than 20% of the US Bond Market. We believe that reducing these highly complex regulations to two relatively simple rules will contribute significantly to the successful implementation of these reporting requirements.

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[13] Sections 171, 1272 and 1276.
[14] Based on statistics published by SIFMA.

Section 4: Transfers of Basis for Fixed Income Securities

The Proposed Regulations with respect to transfers of basis between brokers call for brokers to transfer adjusted basis when custody of a covered tax lot is transferred between brokers and require that substantial additional data be transferred for each covered tax lot[15]. The purpose of this additional data is to allow the receiving broker to carry forward the calculation of adjusted basis begun by the prior broker or brokers. Although we understand this approach, we see many obstacles to its successful implementation and recommend an alternative that allows broker's to transfer original basis rather than adjusted basis.

The FIF Fixed Income survey report[16] shows inconsistency in industry today using different methods for amortization. Differences can arise from different interpretations by brokers of which date to amortize to (e.g. maturity date, one or more call dates, pre-refunding dates, etc.), availability of data (e.g. historical variable rates) or other characteristics of the bond (e.g. tax credit terms). The timing of OID calculations performed by brokers can also result in temporary differences in how brokers would report income on a transfer. A broker that relies on an outside vendor to calculate OID may not initially identify a new bond as subject to OID reporting and therefore may identify all discount as Market Discount rather than partially or fully OID. All of these circumstances will result in situations where receiving brokers will not be able to reconcile adjusted basis numbers reported to them by delivering brokers. Nor will the Service or the taxpayers be able to reconcile those transferred adjusted basis amounts because there is no requirement for broker to report those transferred values to any party other than the contra-broker. The result will be fragmented accounting that the broker who ultimately issues the 1099-B will not be able to fully explain to a client. We anticipate that taxpayers will have questions and will need support in reconciling income reported over prior years when a 1099-B is issued. We believe that requiring brokers to transfer adjusted basis will reduce the broker's ability to support clients and taxpayers in reconciling the values reported.

FIF recommends that broker's transfer the original basis adjusted only for wash sales. Each broker should recalculate adjusted basis based on the security data available to them and the methodology they determine should apply to the instrument. When transferring, the delivering firm should send original price adjusted for wash sales. With this approach, and consistency in amortization and accretion

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[15] Proposed Regulations list eight new data requirements for the transfer of adjusted basis.
[16] See FIF Fixed Income survey report

rules, we are reducing the amount of data required for the transfer and the receiving broker will have all information necessary to calculate accrued Market Discount and report adjusted basis.

Conclusion

The FIF Cost Basis WG appreciates the opportunity to offer our recommendations on the implementation of basis reporting for fixed income securities by brokers. As always, our objective is to facilitate the implementation of this initiative for the industry. To that end, we must reiterate that the industry needs Final Regulations before the end of 2012 in order to comprehensively analyze, develop, test, deploy and communicate the significant systems changes that will be required by the current effective date of January 1, 2014. This amount of lead time is particularly critical for the implementation of new transfer requirements for fixed income, which requires system changes to industry utilities in addition to those by individual brokers followed by interactive multi-party testing.

We welcome additional discussions with IRS staff to further explore any questions on the issues we have raised.

Regards,

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