COMMUNICATING THE IMPACT OF COST BASIS LEGISLATION

Financial Advisors and Tax Professionals are encouraged to collaborate, educate, and help clients plan for the upcoming tax year.

BONDS

The IRS has divided fixed income products into two categories—referred to as "less complex" and "more complex" products for the purpose of cost basis reporting. Cost basis reporting for "less complex" debt instruments began in 2014 Form 1099-B for purchases made on or after January 1, 2014. Reporting for "more complex" debt instruments, including those without fixed yield and maturity dates, will not begin until January 1, 2016. Information regarding "more complex" bonds will be covered in future communications regarding the 2016 legislation changes.

"Less Complex" Covered Bonds include:

- Debt instruments that provide a fixed yield and maturity with established call dates
- Debt instruments that provide for an alternate payment schedule (call feature) for which a yield and maturity can be determined. This pertains to bonds that are callable.
- Demand loans for which a yield can be determined.

*Note: The IRS made a permanent exemption for factor bonds[1] and short-term debt (fixed maturity dates of less than a year from issuance) from the legislation. These security types will remain uncovered.

OPTIONS

OPTION REPORTING

An option, as defined below, becomes a covered security if it is granted or acquired for cash on or after January 1, 2014. An option is also considered to be a covered security if the broker receives the position in a transfer and it is reported as a covered security.

Reportable Options

- An option on one or more specified securities (stock, debt, other options), including an index made of specified securities. Options also include warrants and stock rights.
- An option on the financial attributes of specified securities, such as interest rates on debt instruments or dividend yields on stock.

* Foreign currency options will be permanently exempt.

1 Factor bonds include mortgage backed securities such GNMA, FNMA, collateralized mortgage bonds, etc.

Generally, upon exercise or assignment of an option, the cost or proceeds of that option is reflected in the underlying security for that option, in which case the option itself is not reportable to the IRS. Other option transactions, such as an expiration, will result in an event that is reportable to the IRS. The new regulation requires expired events to show a basis of zero and proceeds to reflect the gain or loss on the transaction.

COMPENSATION BASED OPTIONS

The Treasury mandates that the cost basis for shares acquired via compensation-based options granted after 1/1/2014 should only reflect the strike price multiplied by the number of shares exercised. Taxpayers and their tax advisors will need to make any additional cost basis adjustments necessary at the time of sale of the shares.

FIXED INCOME ELECTIONS FOR BONDS

As part of the legislation requirements, all broker/dealers must support a variety of possible fixed income elections for the purpose of cost basis reporting for bonds.

These elections can potentially have an impact on the yearly income reported by a taxpayer. Discussing the impact that each election could have on future tax returns is a vital part of tax planning. Fixed Income elections can be made to address the following events:

- Amortization of premium for taxable bonds
- Recognition of market discount income
- Market discount computation method

Certain elections are blanket elections for all covered debt instruments held by the client within an account, and will also apply to future purchases of covered debt instruments. Other elections can be made at the CUSIP level for individual debt instruments. Some elections can be revoked if a written request is approved by an IRS commissioner; some are irrevocable.

Elections are limited to individual accounts, on an account-by-account basis. The client will be responsible for ensuring their actions are consistent across firms if assets are held by multiple broker/dealers. Clients will also be responsible for any IRS filing requirements related to elections that are made or revoked. The default election for taxpayers who do not select the option election is set by the IRS — not by the broker/dealer, such as Raymond James.

DISSECTING FIXED INCOME ELECTIONS

UNDERSTANDING THE DETAILS

The table below provides details regarding the elections that pertain to cost basis reporting on bonds. Decisions made for each election may have an impact on the yearly income reported by a taxpayer, and we encourage investors to discuss their election options with a tax professional.

For one-time elections, Raymond James must be notified by December 31st of the year the first covered bond is purchased that meets the criteria of that election. For CUSIP level elections, Raymond James must be notified by December 31st of the year the new CUSIP is acquired by the client.

Reporting Event		Default Election (IRS Requirement)	Optional Client Election	Is This a One-Time Election?	Can I Revoke?*
PREMIUM BONDS	**How do I treat premium for <u>tax exempt</u> bonds?**	You must amortize the premium (reduce cost basis). No offset to interest income because it is tax free.	There is no other option, as the IRS default is the only method.	**No Election – Single IRS Method.** Applies to all covered bonds that are tax exempt and were purchased at a premium.	N/A
PREMIUM BONDS	**How do I treat premium for <u>taxable</u> bonds?**	Use premium to offset (decrease) income yearly. Decrease cost basis; yearly amortized amount on 1099. Report adjusted cost on 1099B.	Do not use premium to offset (decrease) yearly income. Take capital loss instead. Report original cost on 1099B.	**Yes.** Applies to all covered taxable bonds that I own or purchase in and after the year I made the election.	Yes
DISCOUNT BONDS	**How do I <u>report</u> market discount?**	Report accreted market discount as income in the year bond is sold/matured/called. Report original basis on 1099B.	Report market discount as additional income each year and display annual accrual amount on 1099; increase cost. Report adjusted cost on 1099B.	**Yes.** Applies to all covered bonds purchased at a discount in and after the year I made the election.	Yes
DISCOUNT BONDS	**How do I <u>accrete</u> market discount?**	Use *Constant Yield*, also known as *ratable* accrual.	Use *Straight Line* method for market discount accrual.	**No.** Every time I purchase a new covered bond at a discount, I will make this election for each CUSIP during the year I acquired that CUSIP.	No

* Fixed income elections that are revocable must be done through a request to the IRS (approval must be granted by an IRS commissioner). As the broker/dealer, Raymond James will change the election once the client informs their Advisor of their intent to revoke with the IRS, however the client is ultimately responsible for following through with the IRS.

IRS / TREASURY RESOURCES FOR ELECTION INFORMATION

Listed below are the various IRS rules, forms and instructions governing elections and election processing.

AMORTIZATION OF PREMIUM ELECTION

Treas. Reg. § 1.171-1 - Bond premium

Treas. Reg. § 1.171-2 - Amortization of bond premium

Treas. Reg. § 1.171-4 - Election to amortize bond premium on taxable bonds

Treas. Reg. § 1.272-2 Treatment of debt instruments purchased at a premium

REVOKING FIXED INCOME ELECTIONS

Form 3115 - Application for Change in Accounting Method

Form 3115 - Instructions

FINAL REGULATIONS FOR DEBT AND OPTIONS

78 FR 23116 Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options; Reporting for Premium

IMPORTANT FIXED INCOME REPORTING TERMINOLOGY

DE MINIMIS

The de minimis rule governs the treatment of small amounts of market discount. If the amount of market discount is less than 0.25% of the face value of the bond multiplied by the number of complete years between the bonds acquisition date and maturity date, the discount is considered to be zero.

OID (ORIGINAL ISSUE DISCOUNT)

OID is a form of interest and represents the difference between the stated redemption price at maturity and the issue price. OID is primarily associated with zero coupon bonds; however it is possible for a coupon bond to have OID if it is issued below par value. Depending on the issue price of the security with a stated coupon rate, OID may have to be tracked.

AIP (ADJUSTED ISSUE PRICE)

AIP is the original issue price plus any accrued OID from issue date. The AIP is used to determine whether a bond with OID was purchased in the secondary market at a discount or a premium.

MARKET DISCOUNT REPORTING

Please be advised that there are special rules that apply when a taxpayer reports the amount of market discount at the time of sale. Under Section 1276(a) of the tax code, if the current inclusion election is not made, (The default handling for the market discount time of income inclusion election) "gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on the bond."[1] This rule operates to transform what would otherwise be capital gain on the sale of a bond into ordinary income, but only to the extent that gain is realized by the client on the sale.

Broker/dealers are required to report the original unadjusted cost basis, and also the total amount of market discount income, so that the taxpayer has the necessary figures to make this computation. The actual gain or loss and how much is capital gain vs. ordinary income must be evaluated according to Treasury Sections 1276(a).

STRAIGHT LINE (AKA RATABLE) METHOD VS. CONSTANT YIELD METHOD

For each adjustment calculation used by Raymond James, the Treasury provided specific requirements as to the method of computation. For most calculations the constant yield method must be used. For calculating market discount accruals, the default method is Constant Yield, with the option for the taxpayer to elect to use the Straight Line method.

Straight Line: applies a constant dollar amount for each day the security is held over the life of the security.

Constant Yield: Adjustment is based on a yield to maturity (YTM) calculation.

Summary:

- OID is always computed using the constant yield method, based on the original issue price
- Premium amortization is always computed using the constant yield method based on the purchase price
- Market discount will be computed using the Constant Yield method (the default) or the taxpayer may elect to use the Straight Line method. Accruals are based on the purchase price vs. the adjusted issue price at the time of purchase.

1. See Treas. Sections 1276(a)(1)

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