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Invested in America

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Internal Revenue Service
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Re: Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options; Proposed Rulemaking

Dear Ms. Lew,

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to submit additional comments on the proposed regulations being developed to reflect the changes in the law made by the Energy Improvement and Extension Act of 2008 that require brokers to include the customer's adjusted basis when reporting the sale of securities to the IRS. Our first set of comments, filed in February, focused on the need for additional time for brokerage firms to implement the regulations pertaining to options and debt, and we are very pleased that the IRS recognized the need for additional time.

These comments focus primarily on the proposed rules pertaining to reporting of the adjusted basis and long term or short term character for certain options. SIFMA is continuing to evaluate the proposed regulations relating to the adjusted basis and short term or long term character of debt instruments, and we hope to be in a position to comment on those regulations at a later date.

I. Comments on Proposed Cost-Basis Regulations Relating to Options

A. Treatment of 1256 Options

We request that the regulations provide that an option that is a section 1256 contract is not a covered security.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. These companies are engaged in communities across the country to raise capital for businesses, promote job creation and lead economic growth.

The proposed regulations appear to require that a broker report basis information for an option that is a section 1256 contract under the general rules for options and not under the section 1256 rules[2]. Section 1256, affects, among other instruments, "nonequity options" and one other option type not likely applicable here. In general, a "nonequity option" is a listed option that is neither an option to buy or sell stock nor an option the value of which is determined by reference to any stock or any narrow-based security index.[3] In general, a section 1256 contract must be marked-to-market (that is, treated as sold at fair market value on the last business day of the taxable year), and any gain or loss is 60% long-term capital gain or loss and 40% short-term capital gain or loss, regardless of the actual holding period.[4]

Given that section 1256 is mandatory for taxpayers, requiring that a broker report basis information for a nonequity option under the general rules for options would be inconsistent with the mark-to-market rules and result in needless reconciliations by taxpayers. Additionally, for brokers who have been voluntarily reporting basis information of section 1256 options under the mark-to-market regime, system limitations would generally prevent brokers from reporting based on two sets of rules. The first would be based on the mark-to-market rules for pre-effective date options (utilizing the unrealized and realized profit or loss boxes of Form 1099-B). The second would be based on the proposed broker reporting basis rules for post-effective date options.

Multiple and inconsistent reporting methods not only stretch the limits of existent reporting systems, but they have the potential to confuse taxpayers and the IRS. Accordingly, SIFMA recommends that Treasury should not require a reporting method for 1256 options that is inconsistent with the mandatory mark-to-market rules for 1256 contracts. One way to accomplish this would be to provide in the final regulations that an option that is a section 1256 contract is not a covered security.

B. Negative Gross Proceeds Concept

We request that the Form 1099-B reporting of an option that is not exercised and that is sold follow the reporting of sales of all other covered securities.

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[2] Prop. Treas. Reg. § 1.6045-1(a)(14)(iii), (a)(15)(i)(D), (m)(1). In general, an option on one or more specified securities, including an index of such securities or financial attributes of such securities.

[3] IRC § 1256(g)(3), (6). The term narrow-based security index is defined by reference to section 3(a)(55) of the Securities Exchange Act of 1934, as in effect on Dec. 21, 2000. That definition is quite limited and as a result, most listed index options are not narrow-based and therefore, are nonequity options subject to section 1256.

[4] IRC § 1256(a).

Prop. Treas. Reg. § 1.6045-1(m)(3)(i) provides that a broker must increase gross proceeds for all payments received on such an option and decrease gross proceeds for all payments paid on the option. This provision results in the reporting of negative gross proceeds when the amount received on the option is less than the amount paid on the option. (See the Prop. Treas. Reg. § 1.6045-1(m)(5) example.) This provision also presumably results in the reporting of zero in the cost basis box.

Consistent with other covered securities, both a cost basis amount and a gross proceeds amount should be reported on Form 1099-B for such options. For a holder of an option who subsequently sells the option, the cost basis reported should be the amount paid as option premium and the gross proceeds reported should be the amount received from the sale of the option. For a writer of an option who subsequently pays an amount to close out the option, the cost basis reported should be the amount paid to close out the option and the gross proceeds reported should be the amount received as option premium. This is generally consistent with the manner in which systems that currently maintain basis information for options transactions record the transactions, and consistent with both taxpayers' Form 8949 reporting obligations and current IRS Publication 550. Finally, reporting both cost basis and gross proceeds would eliminate the possibility of reporting negative gross proceeds, which would be confusing to taxpayers and challenging to support under US tax law.

C. Definition of Options on Financial Attributes of Specified Securities

The proposed regulations refer to "an option on financial attributes of specified securities, such as interest rates or dividend yields." Prop. Treas. Reg. § 1.6045-1(m)(1)(ii). SIFMA members are unclear as to precisely what Treasury intends will be included in the scope of this phrase. We request that the term "financial attributes" be better explained through the use of examples or by other means. Otherwise, we would like to see it properly narrowed so that the term is more easily understood by our member firms and IRS agents with reason to apply the rule. Consistent with our comments above in Section I, we would also like the final regulations to clarify that this definition does not encompass options that are Section 1256 contracts.

D. Backup Withholding Issue

Under Treasury Regulation section 31.3406(b)(3)-2, the amount subject to withholding with respect to broker reporting is the amount of gross proceeds as determined under Treasury Regulation section 1.6045-1(d)(5). As noted above, under Prop. Treas. Reg. § 1.6045-1(m)(3)(i), for an option that is not exercised and is sold, a broker must increase gross proceeds for all payments received on the option and decrease gross

proceeds for all payments paid on the option. Also, under Prop. Treas. Reg. § 1.6045-1(m)(2), for covered securities disposed of pursuant to the exercise of an option, a broker is required to adjust the gross proceeds amount on the disposition of the securities (by a holder of a put or a writer of a call) to account for any premium related to the option.

The current rule for backup withholding on sales of securities requires withholding on the gross proceeds without any adjustments to account for basis or gain or loss information. One of the reasons why the withholding rule was crafted in this fashion is that it would be extremely difficult for a broker to factor in adjustments to an amount of cash being credited to a customer's account from a sale of securities when systematically applying backup withholding to the cash payment. Typically, any adjustment to gross proceeds to take into account an option premium paid or received will be accounted for in a basis tracking application system and will be uploaded into the Form 1099-B reporting system at year end. Adjustments for premium are not part of the core processing system where the withholding on a sale transaction takes place. This is because the cash from the sale transaction does not move at the same time as the cash from the option premium. For most brokers, when a sale event takes place in an account that is coded for backup withholding, the trade settlement system will automatically withhold 28% of the cash that the customer is entitled to receive. Trades must be processed on trade date. It is not practical to incorporate non-trade related information into the trade settlement process nor is the trade settlement system architecturally configured to do so. Brokers need to have the ability to withhold on the amount of cash credited to the customer's account from a sale in lieu of the amount of gross proceeds as defined in the regulations.

Under current rules with respect to short sales, a broker has the choice to withhold on the gross proceeds or the gain upon the closing of the short sale. A similar choice should be permitted with respect to options. Brokers should be permitted to withhold on either the reported gross proceeds (which would account for the option premium) or the amount of cash credited to the customer's account from a sale (which would not account for the option premium). This would enable all brokers to adapt their specific systems to handle the backup withholding in the most efficient manner.

E. Section 305 and 307 Provisions – 15 Percent Test for Rights Issues.

The proposed regulations on basis reporting for options provide that the term "option" includes a warrant or a stock right (collectively, "rights") issued as part of a corporate action. The proposed regulations provide that a broker must determine the basis in the rights in accordance with the provisions of sections 305 and 307. In general, those

sections provide that the distribution of rights is not a taxable event[5] and that the adjusted basis of the stock with respect to which the rights are distributed (the underlying stock) must be allocated between the underlying stock and the rights in proportion to the fair market values of each on the date of distribution. However, if the fair market value of the rights at the time of the distribution is less than 15% of the fair market value of the underlying stock at such time, the basis of the rights is zero absent a taxpayer election to allocate basis.

The proposed regulations provide that upon exercise or sale of rights, a broker must account for the rights as if they were purchased and must treat as premium paid any basis allocated to the rights (this result is consistent with the result for income tax purposes). Accordingly, in the case of exercise, the basis allocated to the rights is added to the cost of the stock acquired by exercising the rights. In the case of a sale, the basis allocated to the rights is used in determining the gain or loss on the sale. (The results are identical to those of an exercise or sale by a holder of a call option.) If instead the rights lapse, the basis allocated to the rights reverts to the underlying stock.

Brokers are not positioned to undertake client-specific basis adjustments on corporate actions. When a corporate issuer issues rights, the centralized corporate actions function for brokers addresses accounting for those rights across the entire client base. There is no process in place at most institutions to account for later individual client decisions on whether to allow lapse or rights or instead to exercise or sell the rights. We request that the regulations provide that brokers assume rights are distributed in non-taxable events with no shifting of basis, and not compel brokers to build systems to address one-off client decisions made subsequent to the issuance of rights. This would lead to a zero basis for the rights.

F. Compensatory Option Information on Transfer Statements

The preamble to the proposed regulations states that the IRS is exploring the possibility of adding an indicator on the Form 1099-B to denote a sale of compensation-related stock. The proposed regulations provide that a transfer statement must report whether (1) the security was acquired through the exercise of a compensatory option or the

[5] There are a number of exceptions to the tax-free treatment of stock right distributions, including, among others, distributions (i) for which the shareholder may elect stock or cash, (ii) of common and preferred stock, (iii) on preferred stock, and (iv) that are "disproportionate" (in general, distributions that result in an increase in the proportionate interest of only certain shareholders in the assets or earnings and profits of the corporation).

vesting or exercise of any other equity based compensation arrangement and (2) whether basis has been adjusted for any compensation income.[6]

SIFMA requests that brokers be relieved of requirements to provide information related to the compensatory nature of a customer's holdings. A broker often has no way to know whether stock was acquired through such an arrangement. Even if this information resides somewhere within a broker's systems, this information may not be easily accessible to the tax reporting system.

Further, SIFMA members believe that compensation-related stock sales represent a very small percentage of the total stock sales that take place in taxable accounts. We believe that the benefits of implementing these requirements to the IRS and our accountholders do not justify the cost and effort that would be required for many brokers to incorporate compensation-related information into 1099-B reporting. Accordingly, SIFMA recommends that a compensation-related indicator be elective, but not required, on Form 1099-B. Similarly, we recommend that any transfer reporting related to compensation-related information be on a voluntary basis only. Where a broker's systems have easily accessible compensation-related information on a customer's holdings, it could be useful to have the choice to include such information on the transfer statement and Form 1099-B.

If the IRS determines that reporting on the compensatory nature of a holding will be required, we recommend that these requirements be streamlined in the following ways.

First, we recommend that any requirements related to compensatory stock apply only to covered securities. The current transfer statement rules require that a transfer statement for a non-covered security show only that it is non-covered. Financial institutions and their service providers have undertaken substantial effort and expense to build transfer statement systems for stocks and mutual funds. The brokerage industry did not anticipate additional requirements being imposed with respect to transfer statements on non-covered securities and it will be a substantial burden to add data elements to these transfer statements.

Second, with respect to covered securities, we believe that requiring two separate data elements on every transfer statement is not necessary to achieve the objective of capturing the relevant information. We recommend streamlining these requirements so that they apply only if the security was acquired through the exercise of a

[6] Prop. Reg. § 1.6045A-1(b)(1)(viii).

compensatory option or the vesting or exercise of any other equity based compensation arrangement.

Third, we recommend that these requirements be condensed into one data field, the description of which could be phrased as "If the security is known to have been acquired through the exercise of a compensatory option or the vesting or exercise of any other equity based compensation arrangement, indicate whether the basis been adjusted to reflect compensation income." If there is no such indication, the receiving broker would treat the security as one that was not acquired through a compensation-related arrangement. By reducing the requirement to one additional data field, brokers could more efficiently implement the updates to the electronic systems used to transfer basis information and manual transfer statements also would be more succinct. A similar setup could be used for any compensation-related 1099-B reporting.

G. Transfer Statement for Collateral Postings

We also request that the regulations on transfer statements provide that, in general, a person that transfers custody of securities pursuant to the posting of such securities as collateral to a broker is not required to furnish a transfer statement to the receiving broker, provided that the securities are transferred as collateral and both the transferor and the receiving broker are aware of the purpose of the transfer, and the transferor continues to adjust the basis of the transferred securities.

The posting of securities as collateral occurs in a wide variety of financial transactions including repurchase agreements, swaps, and securities loans, in order to protect a party to the transaction against any failure by the other party to meet its obligations. Treas. Reg. § 1.6045A-1(a) provides that, in general, a person that transfers securities to a broker must furnish to the receiving broker a transfer statement that includes, in the case of covered securities, among other things, the adjusted basis and acquisition date of the securities transferred.

The transfer statement furnishes a receiving broker with the basis information necessary for the broker to issue a Form 1099-B should that broker effect a sale of the transferred securities. However, the current rules do not except from the transfer statement requirement transfers pursuant to the posting of securities as collateral. Very often, none of the exceptions to the transfer statement requirement apply, including the exception for a transfer of securities that, after the transfer, are held for a customer that is an exempt recipient.

It is uncommon for a broker that receives securities posted as collateral to be required to issue a Form 1099-B for the securities. In the vast majority of cases, the receiving broker will return the securities (or securities with the same security identification number) to the original transferor. Therefore, we believe it would be unnecessarily burdensome to require a person that transfers custody of securities pursuant to the posting of such securities as collateral to furnish a transfer statement to the receiving broker. The receiving broker typically would have no use for the information on the transfer statement.

Correspondingly, the party that transfers the securities when they are posted as collateral should continue to adjust the basis of the securities because the securities are expected to be returned, and because they remain on the books of the collateral provider in the case of a legal entity.[7] We believe the party that transfers custody of securities posted as collateral should continue to adjust the basis of the securities during the posting period, provided the securities are expected to be returned and the transferor is otherwise required to adjust basis (even though the securities are not in the custody of the transferor).

Our proposed solution to this problem would not necessarily be impacted by shifts in tax ownership. When there is no shift in tax ownership (because insufficient incidents of ownership have passed to the collateral receiver), the receiving broker will, absent a default by the collateral provider, return the securities to the collateral provider upon termination of the collateral requirement.

When there is a shift in tax ownership, IRC Section 1058 should apply in the vast majority of transactions which would result in no taxable disposition by the collateral provider, and therefore, no Form 1099-B to be issued by the receiving broker. Section 1058 should generally apply to such transactions because most securities collateral agreements provide that the collateral receiver ultimately must (absent a default) return securities with the same security identification number as the securities posted as collateral (securities of the "same type, nominal value, description and amount" is common language in collateral agreements). Most securities collateral agreements also provide that the collateral receiver must make payments to the collateral provider of amounts equivalent to distributions made on the securities during the period the securities are posted as collateral.[8]

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[7] Financial statements of entities generally footnote the value of securities delivered as collateral.

[8] IRC § 1058(b) provides that no gain or loss shall be recognized in the case of a transfer of securities pursuant to an agreement so long as, among other things, the agreement provides "for the return to the transferor of securities identical to the securities transferred" and requires "that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which

We believe that the number of taxable dispositions of securities posted as collateral represents an insignificant fraction of the total number of transfers of securities posted as collateral. Further, the number of taxable dispositions by the provider of securities posted as collateral that are "conducted for cash"[9] (and therefore, for which a receiving broker would need to issue a Form 1099-B) is even more insignificant. Certain postings of securities as collateral may result in a taxable disposition of the securities by the collateral provider; for example, perhaps when the collateral agreement does not provide for the return to the collateral provider of the same securities ("same" here means securities with the same security identification number) or when the collateral provider defaults. Certain postings of securities as collateral that do result in a taxable disposition are not "conducted for cash" and therefore, are not subject to Form 1099-B reporting. For example, two parties to a foreign currency contract may agree that the party with an unrealized loss on the open contract must post collateral in the form of securities to the party with an unrealized gain equal in value to the amount of the gain in order to provide assurance to the party with the unrealized gain that it will be compensated in the amount of the gain should the other party default. If the other party does default, the non-defaulting party simply keeps the securities – no cash is paid to the collateral provider as a result of the collateral posting or default.

Notwithstanding the foregoing, we recognize that the government may wish to ensure that a receiving broker does have basis information for securities posted as collateral in a taxable disposition for which the broker would be required to issue a Form 1099-B. Should the government wish to meet this objective, we request that guidance be issued that provides that a party that transfers custody of securities posted as collateral is not required to furnish a transfer statement unless both the broker that receives the securities requests a transfer statement from that party and there is a taxable disposition of the securities that is reportable by the receiving broker. Such a rule would result in a requirement that transfer statements be furnished on an exception basis and only when needed by the receiving broker as opposed to mechanically for all transfers of securities posted as collateral. We believe this approach would minimize the flow of transfer statements with limited value to taxpayers and the IRS.

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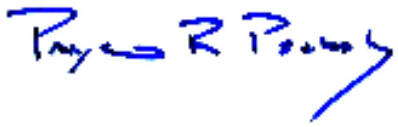
the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor."

[9] Treas. Reg. § 1.6045-1(a)(9) provides that, in general, only dispositions of securities conducted for cash are subject to information reporting by brokers.

II. Conclusion

SIFMA appreciates your consideration of its collective views and concerns on the regulations that are being developed pertaining to the reporting of adjusted basis and long term or short term character of certain options. Please do not hesitate to contact me at (202) 962-7300 or ppeabody@sifma.org if you have any questions or if we can be of further assistance.

Sincerely,



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