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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; Final Regulations

Dear Ms. Lew,

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to submit comments on the final regulations that require brokers to include the customer's adjusted basis when reporting on the sale of covered securities (the "2013 final regulations")[2].

Request for Extension

SIFMA requests that the three year phased effective dates for cost basis reporting on debt instruments and options are each extended one year from January 1, 2014 to January 1, 2015, followed by transfer reporting to January 1, 2016, and finally complex debt to January 1, 2018. We request these extensions both in order to give brokers adequate time to make the programming and systems changes necessary to fully implement the new requirements under the 2013 final

[1] SIFMA brings together the shared interests of securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.
[2] T.D. 9616 (Apr. 17, 2013).

regulations and to ensure adequate resources remain available to comply with the impending Foreign Account Tax Compliance Act ("FATCA") deadlines.

The rules regarding basis adjustment are complex and subject to interpretation, as are the client election rules and associated reporting requirements, which will likely result in discrepancies between firms. Additional requirements centered around third party tax reporting and transfers have yet to be finalized. There are a number of issues outlined in this letter on which we need clarification and guidance in order to comply with the reporting obligations. Following those clarifications, brokers will need adequate time to implement the changes and educate clients.

The layout of certain Forms 1099 is expected to change materially as a result of the new cost basis reporting rules for debt instruments and options, and there will be significant effort required to modify broker systems to conform to the new designs. In addition, brokers that provide substitute Forms 1099 will require a revised Publication 1179 to ensure compliance with permitted formatting standards. As you are aware, neither the final forms nor the publication have been made available to date. Because brokers and third party tax reporting vendors will need the new layouts in final form and the guidance contained in Publication 1179 well in advance of the rules going into effect, there is simply not enough time left for brokers to meet a January 1, 2014 effective date.

These timing constraints are exacerbated by the approaching deadline for FATCA withholding. Many of our members are facing particular difficulty allocating resources due to the proximity of the initial effective dates of the FATCA regulations and the effective date of the cost basis reporting rules. Many of the same systems and resources at our member firms are involved, and both regulations require significant startup prototyping, programming, and testing. Therefore, we urge you to consider an extension to the effective date of the new cost basis reporting requirements to allow financial institutions to finish building and implementing the necessary systems to comply with the FATCA rules, rather than drawing resources away to deal with concurrent cost basis deadlines.

Basis Adjustments in Absence of Election to Include Market Discount on Current Basis

Due to ambiguities in current law and available guidance, there are different views among experts on how to properly account for market discount bonds that are not subject to the current inclusion election. In particular, there is uncertainty on whether the cost basis reported at time of disposition of a covered market discount bond should be the original cost on the bond, or the original cost basis adjusted for the accrued market discount through the life of the bond.

It is unclear to our members what the IRS expects to be reported at time of disposition if the current inclusion election was not made. We believe if brokers were to report the accrued market discount as income then the cost should be adjusted. However, if no such reporting is required then the cost basis should reflect the customer's original cost adjusted solely for OID. We therefore request clarification on how these transactions should be reported to our customers.

Effect of Transfers on Customer Elections

The 2013 final regulations permit a customer to make certain elections that affect how basis is computed, and provide explicit requirements on how the customer must notify its broker of such elections. Under Treas. Reg. Sec. 1.6045-1(n)(5), a valid election must be made to the broker by the customer in writing (including electronically). The 2013 final regulations also require the transferring broker, upon transferring custody of a debt instrument, to provide a transfer statement to the transferee broker that identifies whether any of the information was determined by taking into account one or more elections, and, if so, which elections were taken into account by the transferring broker.

There is uncertainty regarding a transferred debt instrument that the transferring broker or other transferor has indicated on the transfer statement is subject to a customer election. A literal reading of -1(n)(5) would suggest that a transferee broker is not permitted to consider the transfer statement as a valid customer election because it did not come from the customer directly; it came from the transferring broker. Consequently, although the transferee broker would be aware of the customer election made prior to the transfer of the debt instrument, the transferee broker would not be able to treat the transfer statement as a valid election. However, the customer may erroneously believe that the initial written election submitted to the transferring broker remains

valid with respect to the securities transferred and may not consider submitting a second written election to the transferee broker. A customer should not need to submit a written election to the transferee broker that is identical to the one provided to the transferring broker.

Therefore, we request that Treasury should make clear in regulations or otherwise that upon receiving a transfer statement indicating that a valid customer election has been made, the transferee broker be allowed, but not required, to continue to treat the securities transferred as if a valid customer election has been made. We would also note that a delay in the effective date of such guidance would be necessary in order to implement the systems changes and provide necessary client education. Alternatively, if the IRS does not grant an extension of the effective date of the final regulations but does change the regulation, we request penalty relief for those firms that have already begun to program systems and educate clients based on the existing regulation.

Wash Sales for Debt Instruments

SIFMA is requesting additional guidance on wash sales for debt instruments. There appears to be inconsistency among brokers in applying the disallowed loss and days. Some members would like to include the loss in the amortization and accretion, especially if the buys and sells that generate the wash occur in the same tax year. Other members believe that once the wash sale occurs the disallowed loss is maintained throughout the life of the bond and realized fully at time of disposal. We request clarification in the regulations in the form of examples of wash sales that occur in the same tax year and a wash sale that occurs across years, including the impact on the yield or term. Note that these clarifications are likely to result in systems changes for some firms, as such, if there is no extension to the effective date, we request penalty relief for those firms that have already begun to program systems and cannot meet any necessary system changes by 2014.

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The final regulations specifically state that transferors are not required to furnish transfer statements for Section 1256 options. However, we believe that without transfer statements, the receiving broker will not have adequate information for Form 1099-B reporting purposes. The Form 1099-B for regulated futures contracts requires brokers to report: profit or (loss) on closed contracts, unrealized profit or (loss) at the end of the previous tax year, unrealized profit or (loss)

for the current tax year, and an aggregate profit or (loss) figure. To calculate these amounts brokers must know, among other things, the purchase price of the contract. The absence of a transfer statement with cost information on 1256 options will render the receiving broker incapable of reporting the required information on Form 1099-B at year end.

SIFMA therefore requests that transfer statements be required for the transfer of 1256 options. We request that the transferor be required to provide the original basis on the contract as well as the difference between the original basis and the year-end mark-to-market, reported to the IRS in box 10 (Unrealized profit or (loss) on open contracts - 'prior year'). The burden to include that unrealized profit or loss in box 11 on Form 1099-B in the following year should be transferred to the receiving broker. We also request penalty relief for Form 1099-B reporting obligations on transferred Section 1256 contracts until transfer requirements with respect to Section 1256 options take effect. Alternatively, we would request a broad level of penalty relief of debt instruments and options transferred prior to the effective date for account transfers, similar to the relief granted for equity transfer reporting in 2011.

Accretion on Market Discount: Straight Line (Ratable) vs. Constant Yield

SIFMA would also like to request that for covered debt instruments acquired with market discount, the default broker assumption under Treas. Reg. Sec. 1.6045-1(n) be changed from ratable accruals to assume instead that the customer has made the election under Section 1276(b)(2) to accrue market discount on a constant yield basis. Because the constant yield election is generally more favorable to taxpayers, brokers typically assume the election has been made when making voluntary reports to customers. Consequently, clients are used to seeing reports that reflect this beneficial election, and the current rule in the 2013 final regulations will likely lead to client confusion and inconsistencies within accounts, especially as it relates to different assumptions and calculations between covered and non-covered fixed income instruments. We request this change in default but note a delay in the effective date would be necessary in order to implement the systems changes and provide necessary client education. Alternatively, if the IRS does not grant an extension of the effective date but does change the default, we request penalty relief for those firms that have already begun to program systems and educate clients regarding the ratable method.

Compensatory Stock Options and Other Equity-Based Compensation Arrangements

Brokers began reporting cost basis for equities that are covered securities on January 1, 2011. Under the 2010 final regulations on basis reporting for stock[3], brokers were permitted, but not required, to increase the initial basis of stock that is a covered security acquired before January 1, 2013 (the effective date of basis reporting for options under those regulations) as a result of the exercise of a compensatory option or the vesting or exercise of other equity based arrangements by the amount of income recognized upon the exercise or vesting. For the last two years, certain brokers have chosen to reflect the income component of the exercise or vesting when reporting basis to customers on Forms 1099-B.

The proposed basis reporting regulations on options issued in 2011[4] would have allowed brokers to continue the practice of reporting the income component of a compensatory award. The preamble to these regulations also explored the possibility of including an indicator on the Form 1099-B to identify the sale of compensation-related stock. SIFMA requested that such an indicator be elective for brokers, though other industry commentators sought to remove the indicator altogether. Under the final regulations issued in 2013, the IRS not only resolved to forgo the Form 1099-B indicator for compensatory option sales, it went a step further and prohibited brokers from making the income adjustments to the basis of the underlying stock with respect to options granted on or acquired after January 1, 2014. The preamble to the 2013 final regulations states that this break from the prior guidance was made in an attempt to eliminate uncertainty over whether the basis of an employee who had exercised a compensatory option reflected the income component.

We believe that barring brokers from making the basis adjustments will be more confusing and more challenging for taxpayers and the IRS. Clients who had been receiving broker reports that reflected the income component of equity awards in their basis will now have to account for the income component themselves on their Form 8949. In addition, clients of brokers that had been making the basis adjustment for options prior to the release of the 2013 final regulations could potentially see inconsistent presentations on their Form 1099-B when making a sale: for positions relating to pre-2014 awards, gain/loss might be calculated with the income component reflected, while gain/loss on post-2014 awards would not, and it would be up to the taxpayer to reconcile the

[3] T.D. 9504 (Oct. 18, 2010).
[4] REG-102988-11 (Nov. 25, 2011).

different approaches depending on the option grant date. This will be confusing, drive client escalations, and could result in overpayment of tax, as described below.

Under the 2013 final regulations, brokers would be required to report the strike price on the Form 1099-B, despite the fact that the taxpayer's basis for income tax purposes is actually the fair market value at exercise. The income component of the award will continue to be separately reported by the employer on the taxpayer's Form W-2. Consequently, clients who do not have a deep understanding of compensatory stock options may pay tax on the same economic income twice: once, when the income component reported on their Form W-2 is included in their ordinary income, and then again when calculating gain on the award using only the strike price reported on the Form 1099-B. While sophisticated taxpayers may engage professional tax and accounting experts to prepare their returns, we believe that many ordinary taxpayers will end up being subjected to double taxation as a result of this change. It seems fundamentally wrong to devise a rule for brokers that results in the incorrect substantive tax answer for taxpayers in all cases, and disadvantages those taxpayers who do not have access to professional advice.

Consequently, we request that the IRS allow, but not require, brokers to continue the practice of making basis adjustments to account for the income component of compensatory options. Such a rule would be consistent with the rule permitting brokers to make basis adjustments to stock rights and warrants under Sections 305 and 307, depending on the brokers' capabilities. Additionally, in order to provide notice to the IRS and the taxpayer that basis has been adjusted, we recommend the IRS add an indicator on the Form 1099-B to identify the sale of compensation-related stock for those brokers that choose to adjust basis. Upon transfer, brokers agree to send to the receiving broker the cost unadjusted for the income component, making it unnecessary to add an indicator to transfer statements.

Summary

In summary, we believe that additional time is needed to 1) allow the industry to work as a group to standardize calculation methods, 2) allow third party tax reporting vendors to develop requirements for data points and 1099 reporting, and 3) provide more time for the industry to standardize the election handling/reporting process.

SIFMA appreciates your consideration of our views and concerns regarding the 2013 final regulations. As we develop systems, SIFMA anticipates sending additional comments in the future regarding guidance on transfer requirements and requirements for complex debt. Please do not hesitate to contact myself or Jillian Enoch at (202) 962-7300 if you have any questions or if we can be of further assistance.

Sincerely,

Payson R. Peabody
Managing Director & Tax Counsel
Securities Industry and Financial Markets Association