

Understanding the final phase of cost basis reporting

How legislation for fixed income securities and options impacts investors.

For many years, Raymond James has provided cost basis reporting information to clients as a value-added service. As of January 2011, the Economic Stabilization Act of 2008 began requiring Raymond James – along with all broker/dealers, banks, custodians and transfer agents – to record and report more detailed information on securities sales to the Internal Revenue Service (IRS). The final phase of this legislation, which includes certain fixed income products and options, went into effect on January 1, 2016. The regulation phase-in periods for different types of securities are outlined in the table on the next page. Note that the IRS split the population of fixed income products among those with “less complex” features and those with “more complex” features.



KEY TAKEAWAYS

Raymond James is required to report to the IRS detailed cost basis information for covered securities. This white paper should help to clarify what the fourth and final phase of legislation (the inclusion of complex debt fixed income securities and certain options) means for investors.

The IRS has mandated that all firms support a variety of taxpayer elections for the purpose of cost basis reporting on fixed income products.

Account holders remain responsible for reporting all cost basis information on their tax returns and must notify their brokers in writing of their elections or revocations, which are applicable in the calendar year and going forward.

**For more information,
contact your financial advisor.**

ACQUISITION DATE	COVERED SECURITIES SUBJECT TO 1099-B AND IRS REPORTING	COVERED SECURITIES REQUIRED ON TRANSFER STATEMENTS*
1/1/2011	Equities	1/1/2012
1/1/2012	Regulated Investment Company (RIC) and Dividend Reinvestment Plans (DRP) shares ¹	1/1/2013
1/1/2014	Less complex bonds ² and select options ³	1/1/2015
1/1/2016	Bonds with stepped rates, convertible debt, STRIPs, instruments making payments in foreign currency, certain tax credit bonds, PIK bonds, foreign issued debt, debt issued as part of an investment unit and physical certificates held outside a clearing organization. Additionally, contingent payment debt instruments, variable rate debt and inflation indexed debt. Options that are issued as part of an investment unit.	1/1/2017

¹For stock in a RIC (RIC stock) or stock acquired in connection with a DRP (DRP stock), 6045(g)(3)(C)(ii) provides that the applicable date is January 1, 2012. Equities include corporate stock, ADRs, UITs, ETFs, REITs (other than stock in a regulated investment company [RIC] or stock acquired in connection with a dividend reinvestment plan [DRP]). Internal Revenue Code section 6045(g)(3)(C)(i) provides that the applicable date is January 1, 2011.* Legislation requires firms to provide a Cost Basis Transfer Statement when covered securities are delivered to another firm. If no statement is received, a request is made and the position will be considered uncovered. Factor bonds and short term debt will never be covered under the legislation. ²Instruments for which yield and maturity may be determined under §§ 1.1272-1(b), (c), (d). ³Select options to include options on specified securities(i.e., stock, index), on financial attributes of specified securities(i.e., interest rates or dividend yields), stock rights, warrants, and stock acquired through the exercise of a compensatory option(i.e., incentive stock options and nonqualified stock options).

WHAT IS COST BASIS?

The concept of cost basis is simple. It is the price at which a security is acquired. However, calculating cost basis can be complex because the price must be adjusted for factors such as commissions, reinvested dividends, stock splits and other corporate actions. Cost basis is essential in determining how much of a taxable profit an investor has made – or how much of a taxable loss he or she has incurred – on the sale of a security. That profit or loss, in turn, can have an impact on total tax liability.

COVERED AND UNCOVERED SECURITIES

Covered securities are those acquired on or after the applicable dates outlined by the cost basis legislation. Securities acquired by clients before these dates are not covered by the legislation. Broker/dealers are required to report cost basis on covered securities to the IRS. In addition, Raymond James will continue to report cost basis on uncovered securities to clients as a value-added service. Taxpayers remain responsible for accurately reporting cost basis on covered and uncovered securities to the IRS on their tax returns.

RECAP OF 2011 CHANGES

- Raymond James began reporting cost basis information for equities acquired on or after January 1, 2011, to the IRS on Form 1099-B. This reporting includes wash sales and other adjustments. In addition, gifted and inherited shares transferred between accounts must be identified and the applicable accounting rules are applied to the gain or loss.
- Unless otherwise specified by the client or financial advisor at the time of trade or transfer, Raymond James calculates cost basis gains and losses using the first-in, first-out (FIFO) cost basis accounting method, in which the assets acquired first are sold, used or disposed of first.

RECAP OF 2012 CHANGES

- Raymond James began reporting to the IRS cost basis information for covered mutual funds acquired on or after January 1, 2012.
- Average cost became available for mutual funds, certain unit investment trusts and some exchange-traded funds. With average cost, mutual fund shares not covered by the cost basis legislation are averaged separately from those that are covered by the legislation, a division known as “bifurcated cost.”
- Average cost is not as flexible as other available accounting methods, and specific guidelines should be reviewed with a financial advisor.

CHANGES IN 2014 AND 2016

COST BASIS REPORTING FOR FIXED INCOME AND OPTIONS

In April 2013, the IRS finalized the regulations on broker reporting of cost basis for debt instruments and options, completing the final phase of this legislation. The requirements are identical to the obligations for stocks and mutual funds. However, the scope of securities, the number of adjusting elements and the frequency of basis computations are more substantial. Therefore, this final phase of regulation is more complex than those previously covered.

COVERAGE OF FIXED INCOME SECURITIES

For coverage of fixed income products, the IRS decided to bifurcate the population of debt instruments. The IRS split the population of debt instruments into two categories, those with “less complex” features and those with “more complex” features.

Bonds considered “**less complex**” became covered for 1099-B reporting for purchases beginning January 1, 2014. “Less complex” bonds include:

- Debt instruments that provide a fixed yield and maturity with established call dates
- Debt instruments that provide for an alternate payment schedule for which a yield and maturity can be determined
- Demand loans for which a yield can be determined

WHAT ARE DEBT INSTRUMENTS?

A debt instrument is an obligation that enables the issuing party to raise funds by promising to repay a lender according to the terms of a contract. Types of debt instruments include notes, bonds, certificates, mortgages, leases or other agreements between a lender and a borrower.

Bonds considered **“more complex”** became covered for 1099-B reporting for purchases beginning January 1, 2016. These “more complex” debt instruments do not have a fixed yield or maturity date and include:

- Instruments that provide for more than one rate of stated interest (i.e., stepped interest rates)
- Convertible debt
- Stripped bonds or coupons
- Instruments that require payment of principal or interest in non-U.S. currency
- Instruments of a non-U.S. issuer
- Instruments with a payment-in-kind (PIK) feature
- Certain tax credit bonds
- Instruments issued as part of an “investment unit”
- Instruments with physical certificates, unless held by a securities depository or clearing organization
- Variable rate and inflation-indexed debt instruments

The IRS made a permanent exemption for factor bonds and short-term debt with fixed maturity dates of less than one year from issuance. These security types will remain uncovered.

TRANSFER STATEMENTS

For transfer statement requirements, the IRS also took a phase-in approach.

Transfer reporting for “less complex” securities was delayed for one year after the cost basis rules went into effect for the transferred security. Tax lots covered on January 1, 2014, did not require a transfer statement from brokers until January 1, 2015.

Transfer reporting for “complex” securities was also delayed. Tax lots covered on January 1, 2016, did not require a transfer statement from the broker until January 1, 2017.

TYPE	1099 REPORTING	TRANSFER STATEMENTS
Less Complex Features	January 1, 2014	January 1, 2015
Complex Features	January 1, 2016	January 1, 2017

OPTIONS

For coverage of options, the IRS chose to split the population as well. An option becomes a covered security if it is granted or acquired for cash on or after January 1, 2014. An option also will be a covered security if the broker receives the position in a transfer and it is reported as a covered security.

COVERED OPTIONS:

- An option on one or more specified securities – such as stock, debt or other options – including an index substantially composed 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 stocks.

TYPE	1099 REPORTING	TRANSFER STATEMENTS
<ul style="list-style-type: none"> – Options on specified securities (e.g., stock, index) – Options on financial attributes of specified securities (e.g., interest rates or dividend yields) – Stock rights and warrants – Stock acquired through the exercise of a compensatory option (e.g., incentive stock options and non-qualified stock options) 	January 1, 2014	January 1, 2015
<ul style="list-style-type: none"> – Stock right or warrant options issued as part of an investment unit 	January 1, 2016	January 1, 2017

Foreign currency options will be permanently exempt.

SUPPORT OF TAXPAYER ELECTIONS

Announced under the final phase of the legislation is the requirement for all broker/dealers to support a variety of possible taxpayer elections for the purpose of cost basis reporting. Raymond James utilizes the default election to amortize bond premiums in compliance with IRS regulations. In addition, clients have the option to elect from the following:

- Amortization of premium
- Market discount computation method
- Recognition of market discount income
- Currency conversion rate used for foreign currency bonds



Clients should notify their advisors in writing if they wish to make a change to the elections noted above. If a client chooses not to notify the advisor of any specific election(s) in writing, it should be assumed that the client has elected the default method to amortize bond premiums. Some of these elections can be blanket elections for all covered debt instruments held by the client in an account, while others can be made at the CUSIP level. In addition, some taxpayer elections are revocable within a calendar year with permission from the commissioner. Keep in mind that notifying a financial advisor and the IRS of election selections are two separate notification processes. Please refer to the table on the next page for more detail.

What are accretion, amortization and OID?

ACCRETION: The procedure in which certain bond types that are purchased at a discount have cost basis adjusted upward toward par over time.

AMORTIZATION: The procedure in which certain bond types that are purchased at a premium have cost basis adjusted downward toward par over time. The accretion and amortization processes are applied to adjust the cost basis as it reaches maturity.

ORIGINAL ISSUE DISCOUNT (OID): A type of taxable interest that is reported on Form 1099-OID. If a bond is issued at a price lower than par, the difference between the issue price of the bond and the amount received at the maturity of the bond is considered the “Original Issue Discount” (OID). The portion of OID that represents an increase in value each tax year is included as taxable income for reporting purposes and is reportable whether or not payment is received. Such a situation can occur

for both zero coupon and coupon bonds. OID is treated as additional interest that the bondholder will receive at maturity.

For taxable bonds, Raymond James is required to report a client’s OID on their 1099. This will be the client’s taxable interest for their bond.

For OID interest to be calculated correctly, the issue price and date are required. This information is captured for debt instruments purchased through Raymond James. However, for those purchased elsewhere and transferred into Raymond James, the initial purchase price and date are not always available and should be supplied by the client or advisor for accurate calculation.

ELECTION #	REPORTING EVENT		DEFAULT	OPTIONAL CLIENT ELECTION	IS THIS A ONE-TIME ELECTION?	CAN I REVOKE?
N/A	Premium Bonds	How do I treat premium for <u>tax-exempt</u> bonds?	You must amortize the premium (reduce cost basis). It is not used to offset income because it is tax-free.	There is no other option.	NO ELECTION – Single IRS method applies to all covered bonds that are tax exempt and were purchased at a premium.	NO
1	Premium Bonds	How do I treat premium for <u>taxable</u> bonds?	Use premium to offset (decrease) income each year (on 1099). Decrease cost basis.	Do not use premium to offset (decrease) income. Take capital loss instead. Use original basis for gain/loss.	YES – Applies to all covered taxable bonds that I own or purchase in and after the year I made the election.	YES
2	Market Discount	How do I <u>report</u> market discount?	Report all of market discount as income in the year bond is sold/matured/called. Report <i>original</i> basis.	Report market discount as additional income each year (on 1099). Increase cost basis.	YES – Applies to all covered bonds purchased at a discount in and after the year I made the election.	YES
3	Market Discount	How do I <u>accrue</u> market discount?	Use <i>straight line</i> , also known as <i>ratable</i> accrual.	Use the <i>constant yield</i> 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
4	Bonds denominated in foreign currency	How do I report interest paid in foreign currency?	Use the average of daily spot rates for the interest accrual period.	Use the last spot rate of the interest accrual period to translate foreign currency into USD.	YES – Applies to all covered foreign bonds purchased in and after the year I made the election.	NO

WORK WITH YOUR FINANCIAL ADVISOR

Calculating cost basis under this legislation can be quite complex. It is beneficial to have several planning conversations with your financial advisor throughout the year, prior to tax season. Be sure to ask him or her to consult with your tax advisor to gauge the impact on your personal tax situation. Consider these questions the next time you meet with your tax advisor:



- Which election should I select based upon my personal tax situation?
- Which of my investments will be impacted by the legislation?
- How will this legislation impact my 1099?
- Should I just accept the default elections?
- What elections have I been using for reporting in the past?
- How do I revoke an election?

We provided this information to help you understand how this legislation may relate to your specific circumstances. If you have any questions regarding the new IRS cost basis information reporting requirements, please contact your financial advisor for assistance.

Please note, changes in tax laws or regulations may occur at any time and could substantially impact your situation. While we are familiar with tax provisions of the issues presented herein, we are not qualified to render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.

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