

Appendix B

REG-154563-12 Premium subject to reporting for a debt instrument acquired on or after January 1, 2014

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE (IRPAC)

1111 Constitution Avenue, NW, Room 7563, Washington, D.C. 20224

Jeffrey Mason,
Chairperson

July 17, 2013

**Burden Reduction
Sub-Group:**

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Mr. Daniel Werfel
Principal Deputy Commissioner
Internal Revenue Service
CC:PA:LPD:PR (REG-154563-12), Room 5203
PO Box 7604, Ben Franklin Station
Washington, DC 20044

Re: REG-154563-12 Premium subject to reporting for a debt instrument acquired on or after January 1, 2014

**Emerging Compliance
Issues**

Sub-Group:
Susan Boltacz, Chair
Lynne Gutierrez
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Dear Mr. Werfel:

The Information Reporting Program Advisory Committee (IRPAC)¹ is pleased to comment on the temporary/proposed regulations of §1.6049-9T regarding premium subject to reporting for a debt instrument acquired on or after January 1, 2014. These regulations help bring information returns for income and capital into alignment, providing taxpayers with a more complete view of their investments.

With this objective in mind we are addressing reporting for market discount as well as premiums and again bringing your attention to the handling of tax exempt original issue discount. We are also taking this opportunity to provide commentary on the final regulations regarding Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options that were published concurrent with the proposed regulation. We do so because the final cost basis regulations contained substantial requirements regarding support of taxpayer elections that were not part of the proposed regulations and, therefore, not the subject of any industry commentary. IRPAC has several recommendations regarding implementation of these provisions.

Support of the various elections is intended to provide taxpayers with the information required to complete their tax returns. Deploying this functionality to brokerage, cost basis and tax reporting systems is complex and we offer several proposals to address this burden with no material loss of information to taxpayers.

Finally, in recognition of the fact that even the most comprehensive information reporting regime will not anticipate every possible scenario or circumstance, we are providing recommendations for taxpayer resources to complement information returns that we believe will be useful in achieving the most accurate tax returns and smoothest implementation of the new requirements.

We are grateful for the opportunity to assist the IRS in formulating the best possible approaches to serve taxpayers and the financial industry.

Sincerely,



Jeffrey N. Mason

IRPAC Chairman

¹ The Information Reporting Program Advisory Committee (IRPAC) was established in 1991 as a result of an administrative recommendation contained in the final conference report for the Omnibus Budget Reconciliation Act of 1989. The recommendation suggested that the Internal Revenue Service (IRS) consider "The creation of an advisory group of representative from the payer community and practitioners interested in the Information Reporting Program (IRP) to discuss improvements to the system."

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Temporary and proposed regulations

For covered tax lots, the proposed regulations provide guidance for reporting bond and acquisition premium. This information will be new to taxpayers, but will not be available for all tax lots. Additionally, a comprehensive approach to interest income, including market discount, should be considered.

Variability of payee statements

Recipients of Forms 1099-INT will be dealing with a “mixed bag” of information for many years due to the many variables influencing the presentation of information. The Form 1099-INT presents aggregate numbers from which certain details (such as for which lots’ income has been adjusted for premium) may not be discernible for the following reasons:

- Some brokers may provide supplemental information such as premiums on noncovered tax lots while others do not. Additionally, only some brokers’ annual tax statements also include security and payment level detail to support the reported totals.
- Premiums and market discount for noncovered lots may not be available even from brokers that ordinarily provide supplemental information.
- The phase-in of more and less complex tax lots as covered over time will be confusing.
- The impact of premiums may be displayed either as a net number or as a gross amount that must be adjusted for a separately reported amount of premium. Investors will conceivably maintain accounts at firms that employ both reporting styles.

RECOMMENDATIONS

Instructions to recipients of payee statements

Instructions to the recipients of payee statements should stress that although the forms have been enhanced to provide additional useful information, the taxpayer should now exercise even more care to identify amounts that do not appear on the statements but must be considered when completing the tax return.

Substitute payee statements

Firms that use substitute payee statements should be given the latitude to vary the labeling of the boxes containing interest to indicate explicitly when the reported amount is net of premiums.

Current inclusion of market discount

Section 1.6045-1(n)(6)(ii) directs brokers to report amounts of market discount accrued during the calendar year to taxpayers who have made a current inclusion election under 1278(b). There is no indication of where to report and how the income is to be characterized. This is in contrast to the detailed specifications of the proposed regulation for the impact of premiums on income recognition.

RECOMMENDATIONS

To help standardize income reporting on fixed income instruments, IRPAC offers the following recommendations.

Characterize as interest

For several reasons it would be practical and efficient to treat market discount as interest.

- This provides good balance with the treatment of bond premium;
- All bond income would be found on the same form; and
- Publication 550 consistently instructs taxpayers to treat market discount as interest income. Additionally, §1.1272-3(b)(2)(ii), the all OID election, makes clear that market discount is interest income.

Use the final §1.6049-9 to provide detailed guidance for market discount

Market discount income is a natural complement to bond premium. As such, providing guidance for reporting market discount would allow for development efforts across all the income components for fixed income.

Modify Form 1099-OID similarly to Form 1099-INT

Currently, Form 1099-OID may be used to report interest income on a bond in addition to the original issue discount income. Considering that it is possible for an OID bond to be purchased with bond premium, IRPAC offers the following recommendations:

Additional boxes

Be certain that the following boxes are added to 1099-OID as well as 1099-INT

- Acquisition premium; and
- Bond premium; and
- Market discount.

Final cost basis regulations

Section §1.6045-1(d)(6)(iv) makes clear that a broker is not required to make certain adjustments to basis and §1.6045-1(n)(10) states that, "A customer is not bound by the assumptions that the broker uses to satisfy the broker's reporting obligations under section 6045. In addition, a notification to the broker under paragraph (n)(5) of this section does not constitute an effective election or revocation under the applicable rules for the election." Simply stated, no matter what instructions a taxpayer provides to his or her various brokers, there is no guarantee that the payee statements will adequately reflect what is needed for correct completion of the tax return. This potential gap will not be filled by additional information reporting requirements. Therefore, it is important for the IRS to use other means to establish reasonable expectations on the part of taxpayers and provide ample resources devoted to taxpayer education to supplement the information reporting program.

Taxpayer expectations and broker responsibilities

With publication of final regulations [TD 9616] for cost basis of fixed income obligations and options the IRS has developed a comprehensive vision of the computation and transfer of information that will allow taxpayers to accurately recognize capital gains and losses by using the information that is provided to them on the payee statements produced by their financial institutions.

While these reporting requirements will go a long way toward easing the taxpayers' recordkeeping burdens and reducing the opportunity for fraud or miscalculation, it must be noted that there are numerous scenarios in which the information reporting program will not provide the desired continuity. Further, the role of the broker is to follow the instructions of the taxpayer and should not be considered one of enforcement that puts the broker in the position of providing tax advice.

MULTIPLE TAXPAYER ACCOUNTS

It is common for taxpayers to maintain multiple accounts either at the same broker or with several different brokers. As the information reporting requirements are applied account by account, circumstances that are material to the taxpayer's liability will not be captured by the information returns.

Contradictory elections

Brokers are required to follow the written instructions of the taxpayer with regard to elections. Under this requirement, it is easy to see how inconsistent elections might be applied, particularly when accounts are held at different firms.

Wash sales

A taxpayer's investment activity across all accounts must be considered to arrive at an accurate assessment of tax liability. An individual broker will have no knowledge of activity at another firm and most likely not across accounts within the firm either. If the taxpayer has transactions in the same security within different accounts that result in wash sales, the information returns are likely not to be true indications of what the tax return should reflect.

LACK OF WRITTEN INSTRUCTIONS POST TRANSFER

Consider a taxpayer who purchases a bond with market discount and notifies the broker that his or her preference is to recognize the market discount currently. If after several years the taxpayer transfers the position to another broker, the transfer statement will reflect the election that is in force. But suppose that taxpayer notifies the new broker by the end of that calendar year that he or she has revoked the election for current inclusion of market discount, but does not similarly inform the prior broker. In these circumstances, the first broker will issue information returns reflecting market discount income accrued through the date of transfer and will provide a corresponding transfer statement to the receiving broker reflecting an adjusted cost basis that includes accrual of market discount for the current tax year.

OWNERSHIP OF COVERED AND NONCOVERED LOTS

To facilitate implementation, reporting requirements are phased in over time. There are many instances, therefore, in which taxpayers will receive payee statements (and supplemental statements provided as a customer service) that have varying levels of detail for fixed income. This will depend on which firm provides the information, what data was available on transferred positions and which lots are covered or noncovered. The opportunity for confusion or error is exacerbated by these variables.

RECOMMENDATIONS

The additional reporting requirements introduced by the cost basis regulations provide a foundation from which increasingly accurate tax returns will emerge as noncovered lots are retired and transferred positions retain the important history of cost basis. At the same time there are scenarios that can not be entirely anticipated by the information reporting program. Because of taxpayers' expectations that the enhanced information returns are all inclusive of the information they need, it is important that the IRS provide resources that advise taxpayers of their ultimate responsibilities. Additionally, this resource provides an authoritative voice to which brokers may refer taxpayers when questions arise. Toward this end, IRPAC has several recommendations:

Web page

Establish a cost basis web page for taxpayers that explains the elections available and what can be expected of the financial institution. It should also illustrate circumstances in which the information return might be insufficient for accurate completion of a tax return, and guide the taxpayer toward any required adjustments to income beyond what is reported on the information return.

Recipient instructions on information returns

Ensure that the instructions to recipients of information returns stress the taxpayer responsibility to ensure the accuracy of the information, determine what information is not included and adjust accordingly on his or her tax return when certain scenarios are encountered. Stress that a corrected payee statement not always the appropriate remedy for a situation.

Content

In all media, the following points should be emphasized:

- The instructions provided to the broker by the taxpayer do not constitute effective election or revocation under the applicable rules for the election.
- The taxpayer is responsible for the accurate completion of a tax return regardless of what is contained in the information return. Provide examples, such as wash sale situations resulting from acquisitions in accounts held with other brokers, which would not be reflected on the information return.
- The extent of information contained in an information return may vary based on whether a tax lot is covered or noncovered, and that although an information return might be insufficient for completing a tax return, it is not necessarily incorrect.
- Inconsistent elections across multiple accounts will ultimately require additional reconciliation by the taxpayer.
- What constitutes a covered security by asset type and by complexity of fixed income instruments.
- The implications of various elections, for example, when an election must apply to all tax lots or may not be revoked.

The following table is offered as starting point for establishing a taxpayer resource page.

Support of Taxpayer Elections by Brokers					
Election	Broker Default	Taxpayer Election	Revocation	Applicable level	Code and/or regulation
Market discount computation method	Straight line	Constant yield	Not permitted	Instrument by instrument and from the earliest taxable year owned	1276(b)(2)
Recognition of market discount income	At sale, redemption or maturity	Current inclusion	Permitted, with the consent of the Commissioner	All debt acquired during the taxable year of election and thereafter	1278(b)
Amortize bond premium on taxable debt ²	Amortize	Do not amortize	Permitted, with the consent of the Commissioner	All taxable debt held during the year elected and thereafter	171 §1.171-4
Treat all interest as OID ^{3,4,5}	No	Yes	Permitted, with the consent of the Commissioner	Instrument by instrument (taxable) and from the earliest taxable year owned	§1.1272-3
Income conversions to US dollars	Period average	Spot rate on date of payment, credit or receipt	Permitted, with the consent of the Commissioner	All taxable debt held by the taxpayer in the year of election and thereafter	§1.988-2(b)(2)(iii)(B)

The “all OID” election under §1.1272-3

Under the new final Regulation §1.6045-1(n)(4)(iv) pursuant to existing Regulation §1.1272-3, a taxpayer may elect to recognize income on a debt obligation by treating all interest as OID and brokers are required to support this election at the request of the accountholder. Fulfilling this request requires treating the given tax lot as a unique debt obligation for which the taxpayer’s original basis is the issue price, the purchase date is issue date and the periodic payments of interest are nonqualified stated interest. IRPAC recommends that brokers not be required to support this election because taxpayers can get substantially similar results by choosing other available elections and its implementation will be extraordinarily costly and disruptive, for what are expected to be a very small number of instances.

² There is no comparable election for tax-exempt obligations. Brokers must amortize bond premium in this case.

³ Brokers are required to amortize acquisition premium on OID bonds. If the “all OID” election is made by the taxpayer, it effectively changes the method of computing the premium from the “premium fraction” method to a constant yield method.

⁴ Making this election for a bond purchased at market discount assumes the elections to compute discount on a constant yield basis and to recognize the income currently.

⁵ This election is not available for tax exempt obligations.

SIMILARITY TO OTHER SUPPORTED TAXPAYER ELECTIONS

The language of §1.1272-3 indicates that other taxpayer elections are implicit in its selection. The only difference between using the “all OID” approach and the other elections is that with “all OID” the value of cash interest payments become recognizable on an accrual basis rather than a cash basis, which is detrimental to the taxpayer. The table below shows the near equivalence that may be achieved with the other available elections.

Purchase condition	Elections implicit in the 1.1272-3 election
Premium	171(c)(2)- recognition of bond premium (broker default)
Discount	1278(b)- current recognition of market discount 1276(b)(2)- computation of market discount on a constant yield

EXISTING FUNCTIONALITY AND INFRASTRUCTURE DO NOT SUPPORT LOT LEVEL COMPUTATION

For tax information reporting, the existing infrastructure in the financial services industry routinely handles income computations for a variety of fixed income attributes along with the implications of nonqualified stated interest (NQSI). However, extending this capability from the bond level to attributes of individual tax lots is beyond the currently available functionality. Consider the current handling of a bond which (based upon its issuance features) makes periodic NQSI. It is understood that all the interest payments are not reported as income since, as part of the redemption price, the income is captured in the accrual of original issue discount (OID). Information reporting programs customarily report the OID income and do not include interest payments on 1099-INT. This processing decision with regard to how to treat the interest payment is driven by an indicator maintained centrally at the CUSIP number level. When applying this approach based on a taxpayer election, the same process can not be used because the required indicator would have to be maintained at the ACCOUNT-CUSIP-TAX LOT level. This is a fundamental change of granularity, data location and requires far more computation “on the fly” than for other lots.

A further complication arises from the fact that cash distributions such as interest payments are credited to an account per security. This means that no matter how many tax lots have been established for the same CUSIP number, only the amount appropriate to the entire aggregated position is credited to the account. If for some of the constituent tax lots the “all OID” election has been made, an allocation of that payment must be made to determine which portion is reportable on 1099-INT and which is not. The functionality to maintain NQSI at the tax lot level or to allocate interest payments does not currently exist in the industry.

RECOMMENDATION

Because support of taxpayer elections for yield based computation of premium and discount as well as current inclusion of market discount will produce results substantially similar to the “all OID” approach, IRPAC recommends elimination of §1.6045-1(n)(4)(iv). This will remove the significant development burden for a feature that provides no material benefit to taxpayers and would rarely, if ever, be used.

Reporting partial retirement

Section 1.6045-1(a)(9) includes in its definition of a sale (beginning on or after January 1, 2014) “partial retirement attributable to a principal payment.” Conceivably this refers to payments other than qualified stated interest. This requirement raises several issues, as follows:

ADJUSTED COST BASIS FOR A COVERED TAX LOT

If such payments are made on a covered tax lot, the Form 1099-B would have to include an adjusted cost basis. Since this payment is itself (fully or partially) an adjustment to basis, it is unclear what the adjusted basis of the payment would be.

POTENTIAL ALLOCATION OF THE PROCEEDS AMONG OID, MARKET DISCOUNT AND PRINCIPAL

If the principal distribution is made on a bond purchased with market discount, a portion of the proceeds will be market discount income. Similarly, if the bond was issued with OID, a portion of the proceeds will be previously accrued OID. Only after accounting for the accrued OID and market discount would the remainder be considered the principal amount that is an adjustment to basis.

RECOMMENDATIONS

It would be most beneficial to filers of information returns and taxpayers alike if the IRS were to publish illustrations of the expected computation of basis for the payment under a variety of scenarios including a bond with original issue discount and purchases at both a premium and with market discount.

Tax exempt OID

With the proposed regulations regarding amortization of premium, the IRS has taken significant steps to make the information reporting requirements for income and capital more synchronous. With regard to tax exempt obligations issued at a discount there is still a remaining open issue.

INCOME REPORTING NOT REQUIRED

IRS Notice 2006-93 addresses tax-exempt OID by stating, "...no information reporting under section 6049 or backup withholding under section 3406 will be required for calendar year 2006 or thereafter until such time as the Service and the Treasury Department provide future guidance." This notice seems to be recognition of the fact that commercial sources of information for accrual of OID are not available nor are they covered by IRS Publication 1212.

NO DEMINIMIS THRESHOLD

Twenty-eight percent of municipal obligations are issued with some amount of original issue discount. If a traditional de minimis discount threshold is applied, this population shrinks to 2.8%. Also, this much smaller portion is traditionally covered by commercial sources that exist as adjuncts to IRS Publication 1212. Without a source of information for the accrual of OID it will not be possible to compute the adjusted basis for these issues.

Municipal Bond Population as of January 1, 2012	
Description	Count
Total MUNI outstanding as of 1/1/2012	1,529,937
Total MUNI with issue price < 100	430,653
Total MUNI with more than de minimis OID	43,787
Total MUNI with de minimis OID	386,866

RECOMMENDATIONS

Deminimis rule

Temporary regulations for reporting premium under Section 6049 were issued to make information reporting for income conform to basis reporting. To achieve similar conformity for tax exempt issues, IRPAC recommends extension of the de minimis rule of 1273(a)(3) to tax exempt obligations for purposes of OID reporting and corresponding cost basis adjustments. This will make OID reporting and basis reporting possible for the portion of the bond population for which OID accrual data is readily available.

Form 1099-INT

Remember that tax-exempt OID is reported on Form 1099-INT. Therefore, a new box will be required on that form for acquisition premium on tax-exempt issues in addition to bond premium.