

# Communicating the impact of fixed income cost basis legislation

Financial advisors and tax professionals are encouraged to collaborate, educate, and help clients plan for tax season.

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## LEGISLATION FOR BONDS

The IRS has divided fixed income products into two categories – referred to as “less complex” and “more complex” products – for additional cost basis reporting requirements introduced in recent legislation.

Cost basis reporting for “less complex” debt instruments began in 2014 for purchases made on or after January 1, 2014. Reporting for “more complex” debt instruments, including those without fixed yield and maturity dates, began in 2016 for purchases made on or after January 1, 2016.

Any fixed income product acquired before the respective effective dates for “less complex” and “more complex” security types is considered “noncovered” or, in other words, not subject to the additional cost basis reporting requirements.

### “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<sup>1</sup> and short-term debt (fixed maturity dates of less than a year from issuance) from the legislation. These security types will remain uncovered.

### “MORE COMPLEX” COVERED BONDS INCLUDE:

- Bonds that do not have a fixed yield or maturity
- Bonds with stepped rates
- Convertible debt
- Separate trading of registered interest and principal of securities (STRIPS)
- Instruments making payments in foreign currency
- Certain tax credit bonds
- Payment in kind (PIK) bonds
- Foreign issued debt
- Bonds with terms unavailable for more than 90 days after a customer acquisition
- Debt issued as part of an investment unit
- Physical certificates held outside a clearing organization
- Contingent payment debt instruments
- Variable rate debt and inflation indexed debt
- Bonds that are issued as part of an investment unit

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<sup>1</sup> Factor bonds include mortgage backed securities such as GNMA, FNMA, collateralized mortgage bonds, etc.

## 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
- Converting payments in foreign currency to U.S. dollars

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.

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## UNDERSTANDING FIXED INCOME ELECTIONS

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 31 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 31 of the year the new CUSIP is acquired by the client.

### Understanding the Elections for Fixed Income Cost Basis Reporting

Election #	Reporting Event		Default Election (IRS Requirement)	Optional Client Election	Is this a one-time election?	Can I revoke?
N/A	Premium Bonds	How do I treat premium for <b>tax-exempt</b> 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.	<b>No Election</b> – 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 <b>taxable</b> 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. Used original basis for gain/loss.	<b>Yes</b> – 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 <b>report</b> 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.	<b>Yes</b> – 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 <b>accrue</b> market discount?	Use the <i>constant yield</i> method for market discount accrual.	Use <i>straight line</i> , also known as <i>ratable</i> accrual.	<b>No</b> – 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.	<b>Yes</b> – Applies to all covered foreign bonds purchased in and after the year I made the election.	No

## 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

81 FR 8149 Reporting of Original Issue Discount on Tax-Exempt Obligations; Basis and Transfer Reporting by Securities Brokers for Debt Instruments and Options

## IMPORTANT FIXED INCOME REPORTING TERMINOLOGY

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### 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 bond's 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.

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## 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.”<sup>1</sup> 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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