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Calculating Cost Basis for Bonds

Anyone who has ever been baffled by calculating the net proceeds from the sale of a bond will find some relief starting in 2014. Beginning next year, you should start to receive information from your broker that tells you the adjusted cost basis of many bonds and options purchased on or after January 1, 2014.

You may be able to take steps to affect how that cost basis is determined. Because the cost basis reported for your holdings will affect your tax liability on those securities when they're sold, it's important to assess your individual situation and get expert help to make sure it's calculated appropriately.

Background

Cost basis reporting for debt instruments represents the third phase of regulations adopted during the financial crisis of 2008 that require brokers and other financial intermediaries to calculate the cost basis for most commonly traded securities. The legislation was designed to start recapturing tax revenue, estimated by the Government Accountability Office to be worth billions of dollars each year that was being lost because of incorrect cost basis information. You may already have seen some cost basis calculations on your broker's Forms 1099-B over the last couple of years. Cost basis reporting requirements went into effect for stocks as of 2011; mutual funds and exchange-traded funds were covered as of 2012.

Reporting for other securities, including debt instruments, options, and commodities contracts, had been scheduled to begin in 2013. However, because of the greater complexity of the calculations involved, the Internal Revenue Service postponed implementation of that third phase. Typical bonds, which involve interest payments on a fixed schedule and for which maturity and yield can be determined, will now be covered as of January 1, 2014; so will debt instruments that include embedded options. However, the reporting requirements do not apply to short-term debt (any fixed-rate security that matures within a year from issuance), REMIC bonds, or certain other debt instruments whose payments or yield can be affected by prepayments.

Certain options, such as single-stock futures and over-the-counter (OTC) options acquired on or after January 1, 2014, also become subject to the new cost basis reporting rules. Other options, including currency and commodity options and options granted as part of compensation, are specifically excluded from the reporting requirements.

Cost basis reporting for all other debt instruments, which are typically more complex, was delayed even further. Examples of such instruments include convertible bonds, stripped-coupon instruments ("strips"), foreign bonds and those whose payments are made in a foreign currency, certain tax credit bonds, variable-rate bonds and those that offer more than one interest rate (e.g., so-called "step-up" rates), debt that can be redeemed in additional debt from the same issuer ("payment in kind"), inflation-indexed debt, and contingent payment instruments. Securities in the "all other" category will be covered by the regulations as of January 1, 2016.

What does this mean to me?

As with stocks and funds, you won't be the only one receiving your cost basis figures; your broker also is required to report the same information to the Internal Revenue Service. Individual taxpayers (or their tax preparers) will still be responsible for accurately reporting the net proceeds of a sale on their federal income tax returns, but the IRS will now have a better way to double-check those figures.

The new requirements don't mean you can get rid of all records about your bond purchases. The cost basis rules won't apply to bond purchases or options grants before January 1, 2014, so you'll still be responsible for calculating your cost basis for bonds acquired and options granted before that date.

Choices that can affect cost basis

Perhaps the most significant impact of the new rules involves your ability to affect how your cost basis is calculated. According to the rules, you may decide to:

- Amortize any bond premium (a bond's premium is any amount over and above a bond's face value that you paid when you bought it). Amortization allows you to use a small portion of the premium each year to offset the bond's annual interest. Amortization of the premium is the default choice a broker will use unless you instruct otherwise, and it applies automatically to tax-exempt bonds.
- Include any accrued market discount into income currently.
- Accrue any market discount using the constant yield method.
- Treat all interest on a taxable bond as original issue discount.
- Translate any interest and expense on foreign denominated debt at the spot rate.
- If you choose any of the last four methods--i.e., anything other than amortization of a bond's premium--you must formally notify the broker, either in writing or electronically, of your choice.

Determining which method is most appropriate for your individual holdings can be a complicated calculation. Don't hesitate to get expert help in determining which method is most beneficial to you.

Please contact us at (212) 221-7067 if you have any questions or concerns.

Sincerely,

Gassman & Gassman CPA PC

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