Cost basis: Fixed Income elections

In 2013 the Internal Revenue Service (IRS) released final regulations for cost basis reporting on covered securities. In March of 2015 revisions were made to these regulations. For bonds bought on or after January 1, 2014, RBC Capital Markets, LLC (RBC CM) uses IRS default methods to comply with the regulations. Clients have the ability to make the following alternative fixed income elections, which will directly affect the cost basis that RBC CM reports.

Elections for Fixed Income Securities			
	Description	**IRS Default (If No Election Made)**	**Change Due to Election**
Election 1	Amortize bond premium per Section 171 and Regulation 1.171-4.[1]	Amortize the bond premium using the *constant yield* method	• For all bonds bought prior to January 1, 2014, RBC CM continues to amortize the bond premium using the constant yield method. • For taxable bonds bought on or after January 1, 2014, RBC CM will not amortize should you make this election. (Tax-exempt bonds will continue to amortize the bond premium regardless of election.)
Election 2	Include the accrued market discount as income, per Section 1278(b).[1] *(Current Inclusion)*	The accrued market discount will not be included as income on IRS Forms 1099 and will be realized upon disposal.	• For bonds bought prior to January 1, 2014, RBC CM continues to accrete the market discount along with the original issue discount (OID). • For bonds bought on or after January 1, 2014, the market discount will not be included in accretion unless you select the current inclusion election.
Election 3	Method of market discount accretion per Section 1276(b)(2).[1]	Accrete the market discount using the *constant yield* computation method.	• For bonds bought prior to January 1, 2014, RBC CM continues to accrete the market discount using the *constant yield* method. • For bonds bought between January 1, 2014 and December 31, 2014, RBC CM will accrete the market discount using the IRS-mandated *straight line* method per the regulations in effect for tax year 2014. • For bonds bought on or after January 1, 2015, RBC CM will accrete the market discount using the new IRS-mandated *constant yield* method unless you elect the *straight line* method.

[1] "Regulation" refers to U.S. Treasury Regulations. "Section" and "Sections" refer to the Internal Revenue Code.

Important note:

To change from the IRS default elections, clients must provide written instructions to their financial advisor using the RBC CM's Fixed Income Election form. These elections will be applied at the account level. If the client makes no election, RBC CM uses the IRS default.

For "less-complex bonds" bought on or after January 1, 2015:

Due to revisions in regulations, all 2014 regulations remain in effect with the exception of the following changes:

- The IRS default election is the constant yield method of accretion for the market discount

  Clients may elect the straight line method for the market discount accretion

- The election to treat all income as OID has been revoked by the regulations

For "less-complex bonds" bought on or after January 1, 2014, RBC CM is required to:

By IRS default, set clients to the following elections:

- Amortize the premium on all bonds bought at a premium (taxable and nontaxable).

  Clients may elect to turn off amortization on taxable bonds. Nontaxable bonds will always be amortized.

- Not accrete the market discount into the basis of the bond.

  Clients may elect "current inclusion," which will result in accretion of the market discount and increasing the basis.

For "less-complex bonds" bought between January 1, 2014 and December 31, 2014, RBC CM is required to:

- Use the straight line method of accretion for the market discount.

  Clients had the option to elect the constant yield method for the market discount accretion.

- Not treat all income as OID.
- Separate the OID from the market discount and market premium for Form 1099 reporting.
- Apply the de minimis rule to both OID and the market discount/ premium.
- Provide clients the ability to elect computation methods of the market discount accretion using the constant yield method or straight line method (the IRS-mandated default).
- Provide clients the option of computing the amortized bond premium on taxable bonds at the account level.
- Provide clients the option to choose "current inclusion" at the account level.

  Current inclusion" includes the market premium or market discount in the basis adjustment since they are included in the reported OID figure on Form 1099-OID.

Bond amortization and accrual summary

For bonds bought prior to 2014, RBC CM:

- Amortizes the bond premium and accretes the bond discount.
- Amortizes the premium on all bonds bought at a premium.
- Accretes the discount on only original issue discount (OID) bonds if the bonds were bought at a discount to par.
- Computes both of these adjustments (2 and 3 above) using the constant yield method.
- Does not take the bonds' taxability into account.
- Does not take the de minimis rule into account.
- Does not differentiate between which portion of the discount was OID and which portion was additional market discount or market premium.