FINTECH

BASIC WASH SALES

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White Paper

Abstract: This paper serves as an introduction to wash sales, a type of taxable event that results from securities transactions on investment portfolios. It provides a brief history of the laws and regulations that apply to wash sales and discusses how to identify them. The paper also includes examples of securities transactions that result in a wash sale, which always consists of two basic events: a disposition with a loss and a replacement. This paper discusses the three types of replacements: basic, substantially identical, and via a contract or option to acquire substantially identical securities. It addresses the complexity involved in applying the wash sale rule.

By George Michaels

with William Fang

and Daniel Tilkin

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INTRODUCTION

Tax shelters reduce or eliminate taxes due, and a wash sale is a kind of tax shelter. A wash sale exists if you hold a loss position, dispose of it and use a replacement transaction to re-establish the same or (sufficiently similar) position within 30 days before or after the sale. Here's a very simplistic example: you sell stock for a loss and then immediately buy it back.

Wash sales can sometimes occur as a natural result of securities transactions. Other times, savvy taxpayers commit tax shelter fraud by purposefully creating wash sales in order to reduce taxable income and generate artificial capital losses. For tax purposes, recognized losses, especially short-term capital losses, are always desirable; these short-term losses can wipe out your short-term capital gains and help you avoid having to pay the higher 35% tax rate and instead let you pay the lower tax rate of 15%. Regardless of the genesis behind the wash sale, according to Section 1091 of the Internal Revenue Code (IRC), that loss cannot be recognized.

In order to determine which losses can and cannot be recognized or allowed, firms must perform a highly complex process called Tax Analyses of Securities Transactions (TAST). This process helps firms calculate accurate taxable gains and losses on their investment portfolios. Wash sales are just one taxable event that must be identified; other taxable events include straddles, constructive sales and qualified dividends.

The rules for wash sales are specified by I.R.C. § 1091(a):
"DISALLOWANCE OF LOSS DEDUCTION. IN THE CASE OF ANY LOSS CLAIMED TO HAVE BEEN SUSTAINED FROM ANY SALE OR OTHER DISPOSITION OF SHARES OF STOCK OR SECURITIES WHERE IT APPEARS THAT, WITHIN A PERIOD BEGINNING 30 DAYS BEFORE THE DATE OF SUCH SALE OR DISPOSITION AND ENDING 30 DAYS AFTER SUCH DATE, THE TAXPAYER HAS ACQUIRED (BY PURCHASE OR BY AN EXCHANGE ON WHICH THE ENTIRE AMOUNT OF GAIN OR LOSS WAS RECOGNIZED BY LAW), OR HAS ENTERED INTO A CONTRACT OR OPTION SO TO ACQUIRE, SUBSTANTIALLY IDENTICAL STOCK OR SECURITIES, THEN NO DEDUCTION SHALL BE ALLOWED UNDER SECTION 165 UNLESS THE TAXPAYER IS A DEALER IN STOCK OR SECURITIES AND THE LOSS IS SUSTAINED IN A TRANSACTION MADE IN THE ORDINARY COURSE OF SUCH BUSINESS."

We will demonstrate how difficult it can be to apply the wash sale rules because of both the consequences of wash sales as well as the constant creation of new financial instruments.

HISTORY

Congress has had the legal authority to tax income of both individuals and corporations since 1913, when the 16th amendment to the U.S. Constitution made income tax permanent. Since then, Congress has attempted to encourage economic growth and thus increase tax revenue collection through key pieces of legislation. One example is the Revenue Act of 1921, which introduced the wash sale rule — one of the first tax shelters to be disallowed by Congress.

Spearheaded by Andrew Mellon, the Secretary of the Treasury, the Revenue Act of 1921 was put in place as a way to spur economic activity after World War I. The Act set the groundwork for key aspects of our current system of taxation. It differentiated taxation of capital gains (the profit from buying and selling capital assets (investments and property)) from ordinary income. In an attempt to increase tax revenue collection, the Act created the wash sale rule as a way to stop sophisticated investors and taxpayers from committing tax fraud and creating securities transactions to lower their tax liabilities. As part of the wash sale rule, the Act also introduced a new and very loosely defined concept called “substantially identical,” and contained text referring to “substantially identical” securities and how they could not be used to circumvent the wash sale rule.

Before the Revenue Act of 1921, capital gains were taxed at ordinary income rates. However, with the Act, capital assets became part of a special category of property in which gains were entitled to preferential treatment and losses were subject to certain limitations. Capital gains and losses must be claimed on income taxes and, only once the capital asset (investment) is sold, are subject to either long-term (an investment held for more than one year) or short-term (an investment held for one year or less) tax rates. Long-term capital gains are taxed at a lower rate than regular income. This was instituted as a way to encourage long-term capital investments, which in turn could help stimulate economic growth and thus increase revenue (tax) collection.

The Obvious and Not So Obvious

The wash sale rule was intended to stop astute taxpayers from purposefully manipulating securities transactions and creating wash sales as a way to “harvest taxable losses” and thus minimize tax liabilities. For example, savvy taxpayers who wanted to game the system might dispose of a loss position, use that realized loss to offset a realized gain elsewhere, and quickly re-establish the loss-carrying position. Thus, the taxpayer kept his holdings unchanged, but still benefited from the reduction in realized gain. Sometimes this kind of tax fraud is obvious and other times, it is not-so-obvious. Here's an example of an obvious wash sale involving identical stocks: you sell stock ABC for a loss and then immediately buy back stock ABC. Per the wash sale rule, those losses cannot be recognized.

To try and curtail the not-so-obvious tax shelter abuse, Congress introduced the term "substantially identical" as a way to stop sophisticated taxpayers from replacing the original security with a technically different securities that could be sufficiently similar and therefore serve as a substitute. Here's an example of a wash sale involving "substantially identical" securities. On July 24th, 1953 a taxpayer sold 2.25% treasury bearer bonds maturing December 15, 1959 at a loss and then immediately bought 2.25% treasury registered bonds maturing June 15, 1959. The IRS ruled that the two bonds were "substantially identical" and disallowed the loss. The term "substantially identical" is poorly defined in the IRC. As a result, since 1921, a number of IRS and court decisions have been needed to clarify to which cases the wash sale rule applies. For a more in-depth discussion of this ambiguous term, please see our white paper, Using Market Risk Concepts to Refactor Tax Shelters.

SHORT SALES AND WASH SALES

To widen the universe of situations where the rule applies, over the years the basic nature of the rules themselves has been changed by Congress multiple times via legislation. Short selling is a good example. A short sale is basically borrowing stock and selling it in the marketplace prior to ever owning it. This is done as a speculative move, usually in anticipation of a decline in price. When selling short, you have an obligation to return the borrowed shares at a later date. The replacement shares can either be acquired in the market after the short position was entered into, or they can be shares already held at the time of the short. Short selling was not as commonplace in 1921 as it is today. As a result, the drafters of the original 1921 Act addressed wash sales only in relation to long positions. The Deficit Reduction Act of 1984 amended the wash sale rule to include short sales.

WASH SALE GUIDELINES & CONSEQUENCES

Guidelines

According to the Internal Revenue Service rules, you cannot deduct losses from sales or trades of securities in a wash sale. A wash sale occurs when you sell or trade securities at a loss and within 30 days before or after the sale you:

- Buy substantially identical stock or securities,

- Acquire substantially identical stock or securities in a fully taxable trade, or
- Acquire a contract or option to buy substantially identical stock or securities

Consequences

There are three consequences to executing a wash sale:

1. **You may not recognize the loss on the original position from the wash sale.**

2. **You must adjust the date of acquisition of the replacement stock to take into account the time that the original position was held.** For example, if you were to buy a stock on day 1, sell it on day 45, and immediately repurchase the same amount of stock on day 45, then you would treat the new shares as if they were purchased on day 1 for determination of long-term or short-term capital gains when those shares eventually are disposed of. There are multiple interpretations of what this means. For a more in-depth discussion on this topic, please refer to paper our white paper, Holding Period Adjustment Methods for Wash Sales.

3. **When you do eventually dispose of the replacement securities, you may then recognize the loss that was disallowed in part 1.** This is achieved by adjusting the cost basis of the replacement securities by an appropriate amount. However, recognition of a loss on this disposition may in turn be disallowed if it is deemed that a new wash sale has been triggered.

IMPORTANT CONSIDERATIONS

- You can recognize the loss if you were to wait more than 30 days before you re-enter the position.

- If you realize the loss due to covering a short position, the wash sale rule takes effect; it is not only for long positions. I.R.C. § 1091(e)

- If the replacement position is created on a related security, you may or may not have a wash sale depending on the replacement rules (discussed below).

- If the new position is in the opposite direction (long vs. short), you won't have a wash sale.

- If your replacement position is acquired before the disposition, the wash sale rule still applies as the 30-day window works chronologically in both directions.

- You do get to eventually recognize the loss, but only later when the replacement position is disposed of, though there are limitations to this rule.

- Once used as a replacement, a given share cannot be used as a replacement in a separate wash sale. This is informally known as “the one bite of the apple” rule. 26 C.F.R § 1.1091-1(e)

WASH SALE REPLACEMENTS

Wash sale replacements fall under three categories: basic, substantially identical and contracts & options. Some replacements are easy to identify and others are more difficult.

Basic Replacements

Any time the taxpayer disposes of a tax lot at a loss and then repurchases the same security within 30 days, these securities transactions trigger the wash sale rule.

Substantially Identical

Any time a taxpayer disposes of a tax lot at a loss and then purchases a substantially identical security within 30 days to replace the retired securities of the disposed lot, this series of securities transactions triggers the wash sale rule. Since there is no clean, easily applicable definition for “substantially identical,” sometimes we can only speculate in certain cases as to whether two securities meet the IRC criteria. Many times these cases closely resemble others that have been previously ruled upon. However, in the absence of a law, regulation or ruling, ultimately it is left to the taxpayer to decide whether or not to invoke the rule. It is important to note that since the wash sale rule almost always benefits the U.S. Treasury, if you have any doubts, you can usually be safe by invoking the wash sale rule. To the best of our knowledge, the IRS has never taken anyone to court for being too aggressive in declaring wash sales.

Our discussion of “substantially identical” will continue in future white papers that address advanced wash sales.

Contracts and Options

A number of securities can serve as replacement securities for those retired in the disposed lot. These include contracts and options to acquire the original security as well as securities that are substantially identical to the original security. One also must consider options or contracts to acquire securities that are substantially identical to the original security.

Long Call Options, Warrants and Rights Issues – These are all contracts or options to acquire the stock per I.R.C. § 1091 (a).

Short Put Options – Revenue Ruling 85-87 states that a short put option can sometimes be considered "an option to acquire" its underlier if it is virtually certain that the option will be exercised.

Long Put Options – A long put option would presumably be considered an "option to acquire" the short position under I.R.C. § 1091(e).

Short Call Options – We can also presume that Revenue Ruling 85-87 in conjunction with 1091(e) would apply to a short call option serving as a replacement for a short underlier position.

Convertible Securities – The convertibility feature of certain securities has been explicitly called out by Revenue Ruling 77-201 as to trigger the “option to acquire the stock” rule under certain conditions.

BRANCHING AND CHAINING

When deciding how to identify wash sales and calculate disallowed losses, sublots (branching) and transaction scenarios (chaining) play a very important role. They can both occur simultaneously and quickly result in extraordinarily complex consequences.

Branching

Branching occurs when a lot is broken into separate components (sublots) based on the replacement lot size. Per the wash sale rule, when the replacement lot is larger than the original lot, only a portion of the replacement lot has its basis adjusted. Conversely, if the replacement lot is smaller than the original, then only a portion of the original loss is disallowed.

In the case where the replacement is larger, one sublot (A) is created whose size is identical to the original lot. The other sublot (B) contains the balance of the replacement lot's position. Sublot (A) has its cost basis and acquisition date adjusted according to the wash sale rules and sublot (B) retains the original cost basis and acquisition date of the replacement lot.

In the case where the original is larger, it is also broken into two sublots. The first sublot (A) is created with a size equal to the replacement, and its loss is disallowed. The other sublot (B) contains the balance of the original lot's position and its loss may be recognized.

Note that in both cases, multiple sublots can be created since multiple wash sales impact the same lot. In other words, the branches can branch.

Chaining

Chaining is the result of a consecutive series of Buy-Sell-Buy scenarios (Buy-Sell-Buy-Sell-Buy). There is no limit to the number of potential trades in a single chain. Chaining becomes especially complex when the cost adjustment to the original replacement Buy creates a subsequent wash sale. This occurs because the cost basis of the replacement Buy is reduced by a sufficient amount to cause a subsequent sale to be a loss instead of a gain. This scenario creates additional replacement Buys, whose holding periods must be adjusted using different methods. Please refer to paper our white paper on this topic, Holding Period Adjustment Methods for Wash Sales.

The chaining effect dictates that the cost basis adjustment affecting a replacement position must be taken into account when determining the amount of recognizable loss that occurs due to this position being retired. This can adjust forward the gain or loss from the retirement as well as change its character. Three potential effects can result. (1) If the position is disposed of for a gain, that gain can be reduced. (2) However, if the adjustment is deep enough, the gain can become a loss, which therefore makes the disposition a candidate for a new wash sale. (3) If the disposition was made at a loss, the amount of loss is increased. The interesting effect is that the original loss can be carried forward through a sequence of dispositions that can be viewed as a "chain." Chains can occur over multiple years and have as many links as needed.

EXAMPLES

Example 1 – Simple Wash Sale

Activity: The taxpayer buys a single share of stock ABC on January 3rd of 2011 for $125. On January 31st, the taxpayer sells one share of stock ABC at $100. Also, on January 31st, the taxpayer buys one share of stock ABC at $105.

Result: January 31st is obviously within the 30-day window that surrounds January 31st. Therefore, the taxpayer may not deduct the $25 in loss realized on January 30th. Instead, that loss adjusts the cost basis of the long share to $130 ($105 original cost plus $25 disallowed loss) with a tax date adjustment that sets the acquisition date to January 3rd.

Example 2 – Short Wash Sale

Activity: The taxpayer shorts a single share of stock ABC on January 3rd of 2011 for $100. On January 31st, the taxpayer covers the short by buying one share of stock ABC at $125, which settles on February 3rd. On March 2nd, the taxpayer shorts one share of stock ABC at $105.

Result: For a cover short transaction, the settlement date is used instead of the trade date as the center of the 30-day window. March 2nd is within the 30-day window from February 3rd. Therefore, the taxpayer may not deduct the $25 in loss realized on January 30th. Instead, that loss adjusts the cost basis of the short share to $80 ($105 original cost adjusted by the $25 disallowed loss) with an appropriate adjustment to the holding period of the replacement share.

Example 3 – Order-Independent

Activity: The taxpayer buys a single share of stock ABC on January 3rd of 2011 for $125. On March 31st, the taxpayer buys one more share of stock ABC at $105. On April 30th, the taxpayer sells the share of stock ABC purchased on January 3rd for $110.

Result: It is important to remember that the replacement position may have been acquired before the retirement. Therefore, the March 31st buy is a replacement leg, opening the window for the April 30th loss to become a wash sale, disallowing the $15 realized loss. In the end, the taxpayer is long one share of ABC with a cost basis of $120 and an appropriate adjustment to the holding period.

Example 4A – Branching the Original Lot

Activity: The taxpayer buys two shares of stock ABC on January 3rd of 2011 for $125. On January

31st, the taxpayer sells two shares of stock ABC at $100. On March 1st, the taxpayer buys one share of stock ABC at $105.

Result: As in Example 1, the March 1st sale is a wash sale. The investor must break his position of two shares into two sublots, each of one share. We will label them (A) and (B), where A is the sublot used for the wash sale. As in Example 1, sublot A is replaced resulting in the replacement sublot carrying a cost basis of $130 and with an appropriate adjustment to the holding period. Sublot B produces a recognized loss of $25 that is allowed.

Example 4B – Branching the Replacement Lot

Activity: The taxpayer buys one share of stock ABC on January 3rd of 2011 for $125. On January 31st, the taxpayer sells one share of stock ABC at $100. On March 1st, the taxpayer buys two shares of stock ABC at $105.

Result: As in Example 1, the March 1st disposition is a wash sale. The investor must break his March 1st buy of two shares into two sublots, each of one share. We will label them (A) and (B), where A is the sublot used as a replacement for the wash sale. As in Example 1, sublot A is adjusted to carry a cost basis of $130 and with an appropriate adjustment to the holding period. Sublot B remains at its original cost basis and holding period.

Example 5 – Chaining

Activity: The taxpayer buys a single share of ABC on January 3rd of 2011 for $125. On January 31st, the taxpayer sells that one share of ABC at $100. On March 1st, the taxpayer buys one share of ABC at $105. On May 30th, the taxpayer sells that one share of ABC at $120. Finally, on June 29th, the taxpayer buys one share of ABC at $125.

Result: The trades on January 3rd, January 31st, and March 1st result in a buy dated March 1st with a cost basis of $130, as explained in Example 1. Therefore, the May 30th sell at $120 exhibits a loss of $10. But the subsequent June 29th buy serves as a replacement leg for this loss. Therefore, the $10 loss is now disallowed, and this results in a $10 adjustment to the lot acquired on June 29th. In the end, the taxpayer is long one share of ABC with a cost basis of $135 and an appropriate adjustment to the holding period.

Example 6 – Call Option

Activity: The taxpayer buys 100 shares of ABC on January 3rd of 2011 for a total of $12,500. On January 31st, the taxpayer sells those shares of ABC for $10,000. On March 1st, the taxpayer buys a call option contract to acquire 100 shares of ABC for a total cost of $100.

Result: In this example, the call option is a replacement. Therefore, the $2,500 realized on January 31st is disallowed. Instead, the cost basis of the call is adjusted from $100 to $2,600. Note the strike price of the option is irrelevant.

Example 7 – Substantially Identical – Convertible Preferred

Activity: The taxpayer buys 1 share of convertible preferred share ABC_CP in company ABC on January 3rd of 2011 for $3,933. The conversion ratio is 207 (one share of ABC_CP is convertible to 207 shares of ABC). On February 15th, the taxpayer sells the 1 share for $3,001.50 and on the same day purchases 207 common shares of ABC at $14.50 per share. Assume the convertible security ABC_CP in this case meets the conditions laid out by revenue ruling 77-201 so as to be considered substantially identical to its underlier ABC.

Result: This series of trades results in a wash sale. The loss of $931.50 is disallowed. In the end, the taxpayer is long 207 shares of ABC with a total cost basis of $3,933 and an appropriate adjustment to the holding period. On a per-share basis, this is equivalent to the per-share cost basis of ABC adjusted from $14.50 to $19. The $4.50 per share adjustment is derived from $931.50 divided by 207 shares.

Example 8 – One Bite of the Apple and Chronological Order

Activity: The taxpayer buys 2 shares of ABC on January 3rd of 2011 for $125 per share. On March 31st of 2011, the taxpayer sells 1 share of ABC for $100; on April 5th of 2011, the taxpayer sells the remaining 1 share of ABC for $110. Finally, on April 30th of 2011, the taxpayer buys 1 share of ABC for $105.

Result: This example illustrates two intertwined concepts: (1) One Bite of the Apple and (2) First In First Out (FIFO). Clearly, the taxpayer has created a wash sale with the replacement buy of 1 share on April 30. However, because the replacement is for just 1 share, only the loss from one of the sales (March 31 and April 5) is disallowed. This is the One Bite of the Apple principle.

But which one loss should be disallowed? The $25 from March 31 or the $15 from April 5? When multiple losses might be disallowed by the wash sale rule, the taxpayer must start with the earliest realized loss and process the remaining losses chronologically. In this case, the $25 loss from the March 31 sale is disallowed, and the April 30th buy serves as the replacement. When we look at the April 5th sale, there are now no shares left that are eligible to be a replacement. This is the chronological order principle or FIFO.

In the end, the taxpayer is long one share of ABC with a cost basis of $130 and an appropriate adjustment to the holding period; and a recognized loss of $15.

CONCLUSION

The wash sale rule has been around for over 90 years and continues to be highly relevant today. While it is true that some very basic wash sale cases exist (see Example 1), other more complex cases also exist and as a result, wash sales analysis can be very complex. This complexity is exacerbated because of the ambiguous definition behind term "substantially identical," and the constantly growing volume of trades. Once branching and chaining effects are taken into account, the calculation of wash sales on just a single security is difficult. This paper focuses on basic wash sales. However, determination of wash sales becomes even more difficult when more advanced topics, such as corporate actions (e.g., mergers and acquisitions) and interactions with other sections of the tax code (e.g., straddles and constructive sales) are relevant.

This white paper is part of G2's **Tax Analysis for Securities Transactions (TAST) Resource Page** (http://g2ft.com/resources/), which provides best practice guidelines on IRC compliance. G2 also hosts a Taxable Events Webinar Series. For more information, visit http://www.g2ft.com/webinars/.

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