Advanced Topics in Wash Sales: Substantially Identical Bonds*

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White Paper

Abstract: This paper discusses the challenges tax practitioners and compliance officers face when trying to determine whether two different debt securities are Substantially Identical (SI) to one another and can thus trigger specific rules within section 1091(a) (Wash Sales) of the Internal Revenue Code (IRC). Proper application of the wash sale rule can be quite complicated because of the inherent complexity of debt securities and quandaries about how to interpret "Substantially Identical," a poorly-defined term. A fair amount of complexity also arises when the instruments in question possess option-like characteristics, but that falls outside of the scope of this paper. This paper examines the different sources of information regarding how to apply the term SI to debt securities. Specifically, the paper discusses the 1939 seminal court case *Hanlin v. Commissioner* as well as a series of pertinent Revenue Rulings.

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* This white paper is a work in progress. We are currently requesting comments on its contents as we complete the final version of this paper. Please send your comments to jmichaels@g2ft.com. We look forward to hearing from you.

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INTRODUCTION

Debt instruments are part of a broad asset class that includes many different kinds of securities. Varying definitions for this term exist. For the purposes of this paper, we offer the following working definition for debt:

An investment that provides a return in the form of periodic payments and the eventual return of principal (provided there is any) at maturity. The amount of each payment uses a predetermined formula agreed upon by the buyer and seller of the security in question.

This broad definition covers a plethora of different securities including, but not limited to, the following:

- United States Government Bills, Notes and Bonds
- Foreign Sovereign Short-term and Long-term Debt Instruments
- Domestic and Foreign Corporate Debt
- Money Market Securities
- Savings Bonds
- Junk Bonds
- Convertible Bonds
- Asset Backed Securities (FNMA, SLMA, etc.)
- Interest Rate Swaps
- Forward Rate Agreements
- Bank Debt
- Commercial Paper
- Credit Default Swaps

Unlike equities, most debt securities are inherently highly complex investments. They are subject to a wide range of terms and conditions, such as maturities, principal amounts, coupon schedules and seniority issues that determine their value. This complexity makes it difficult to compare two different debt instruments and establish whether or not they qualify as substantially identical, a term integral to the wash sale rule.

The Wash Sale Rule

The purpose of the wash sale rule is to prevent taxpayers from harvesting losses during a tax year by selling securities in their portfolio and immediately repurchasing them at the exact same price in order to reduce their tax liability. Introduced with the Revenue Act of 1921, the wash sale rule was among the first tax shelters to be disallowed by Congress. This rule became necessary once capital gains and losses were no longer taxed at ordinary income rates, yet another facet of the Revenue Act of 1921.

The wash sale rule basically states that if you hold a loss position, dispose of it and you re-establish the same (or sufficiently similar) position, then you have a wash sale and cannot recognize that loss for tax purposes. In a very simplistic example in involving equities, if you sell a stock for a loss, and immediately buy it back, you have a wash sale. (See our whitepaper, Basic Wash Sales, at http://g2ft.com/papers/.

Specifically, Section 1091(a) provides that “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 § 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."

From this text, we can see that losses are disallowed not only when the taxpayer purchases (or enters a contract or option to acquire) the *same* security at a loss but also when the taxpayer purchases (or enters a contract or option to acquire) a SI security at a loss. But what exactly constitutes substantially identical? Historically, this concept has been poorly defined (See our white paper, Using Market Risk Concepts to Refactor Tax Shelters, at http://g2ft.com/papers/) and thus been open to interpretation and the source of many headaches for tax professionals and compliance officers.

One Term, Many Sources

More than 90 years ago Congress introduced the term "substantially identical" to the IRC as a way to try and curtail the not-so-obvious tax shelter abuse. Dr. Adams, Treasury department tax advisor, is credited with including this new and loosely defined term in the wash sales rule. It was added as a way to stop sophisticated taxpayers from replacing the original security with a technically different security that could be sufficiently similar and therefore serve as a substitute in securities transactions. Since then, laws have reused this term with presumably the same intended meaning. Just as new laws have extended and enhanced the tax code (IRC), the meaning of SI has also continued to evolve.

"Substantially identical" was so poorly defined when initially introduced in 1921, that ever since then, Congress, the IRS and the U.S. Tax Court have created a collection of laws, regulations and rulings to more clearly define this vague concept. Tax practitioners and compliance officers can find reference to this term in no less than three sources:

- Internal Revenue Code [1](IRC)
- Code of Federal Regulations (CFR)
- Revenue Rulings (RR)

In addition, this concept is also discussed in legal precedents, many from the United States Tax Court.

Navigating between these sources can be quite challenging. They are written by different entities -- the IRS and Congress -- who have different purposes and goals. The IRS is the federal government's revenue-collection arm. The primary function of Congress is lawmaking.

The IRS is responsible for a section of the Code of Federal Regulations (CFR) governing how to correctly pay taxes. The author of the IRC, the definitive source for all U.S. tax laws, is Congress. These sources do not always share and/or borrow information from one another. In addition, on an as-needed basis, the IRS periodically enhances the IRC and CFR with Revenue Rulings. In these rulings, the IRS examines a specific tax case, makes certain decisions (rulings), and also explains how those rulings are reached. Not every Revenue Ruling makes its way to the CFR, and sometimes the IRS injects new text directly into the CFR that is not drawn from Revenue Rulings. Therefore, it is necessary to draw from all three sources of documentation (IRC, CFR, RR) when discussing the concept of Substantially Identical.

[1] The IRC was enacted as Title 26 of the U.S. Code by Congress. Originally compiled in 1939, the code has been revised in 1954 and then again in 1986.

Although it is critical to understand all of this documentation -- the IRC, CFR and RR -- when trying to establish whether or not two debt securities are substantially identical to one another, the U.S. judicial system is always the ultimate arbiter of whether two securities are or are not SI. Legal precedent can therefore override any of the above documents with regard to defining SI. As a result, in order to apply the term substantially identical to debt securities in the most accurate and comprehensive manner, we also need to examine relevant historical court cases and the legal precedents that followed them.

This paper explores certain IRS and Tax Court Rulings as well as the text of the Code of Federal Regulations to illustrate the government's thinking on the interaction between 1091(a) and debt securities with specific attention paid to how Substantially Identical applies. It is not an exhaustive exploration but it does cover many of the critical elements that should be considered by a practitioner when trying to determine the application of the rules relevant to calculating adjustments to gains and losses.

The focus of this paper is wash sales (section 1091) and SI; however, other sections of the IRC also include this term. "Substantially Identical" also appears within sections 1233 (short sales) and 1259 (constructive sales) of the IRC. The CFR, which governs section 1233, specifically states: "the term [SI] has the same meaning as the term *substantially identical stock or securities* used in section 1091." The discussion of this applicability is outside the scope of this paper.

SEMINAL COURT CASE

Hanlin v. Commissioner

The 1939 *Hanlin et al v. Commissioner* court case shone the spotlight on the term substantially identical, debt securities and the wash sale rule. This seminal case was the first to lay down some general guidelines for determining whether two different bonds (of any type) were SI to one another and has influenced subsequent rulings ever since.

In the *Hanlin v Commissioner* case, the United States Court of Appeals for the Third Circuit Court in Philadelphia was asked to rule on the appeal of *Hanlin et al v. Commissioner*. The court examined a series of transactions involving bonds that a taxpayer had seemingly used to create "wash sales" in order to harvest tax losses. In question were two distinct but very similar bonds issued by the City of Philadelphia.

The court sought to bring some clarity to the term substantially identical, but also acknowledged that the "elastic weasel word," **substantially**, created "uncertainties" in the application to real-world situations. The Court also asserted "that something less than precise correspondence will suffice to make" two securities substantially identical.

In the end, the Court concluded these two Philadelphia-issued bonds were SI to one another. In order to come to this determination, the Court closely examined and compared several key elements of these bonds: timing of purchase versus maturity and interest rates.

Timing of purchase versus maturity

According to the *Hanlin v Commissioner* case, the timing of purchase versus maturity must be examined in order to determine if two debt securities are SI. Let's use the example of two bonds that mature within 6 months of each other twenty years in the future. Assuming all other factors are not substantially different, the taxpayer would have to consider these two bonds to have non-substantial differences in maturity. However, 19 years from now, should the taxpayer consider the same two bonds, when one matures in 6 months and the other matures in 12 months, now the argument can be made that the maturities are substantially different. To quote the Third Circuit, "six months added to a duration of one year is vital -- added to a duration of twenty years, negligible."

Interest rates

The *Hanlin v Commissioner* case also addresses interest rates; it states: "the importance of yield brings about a corresponding triviality in the unproved yet possibly cognizable dissimilarity in the redemption dates of the two sets of … bonds." This text implies that the tax court believes it is possible for two distinct securities to sometimes be substantially identical based on timing and market conditions. This carries analogies to the structure of the text in Revenue Ruling 56-406 on Stock Warrants (see our upcoming white paper, Advanced Topics in Wash Sales: Options, Rights and Warrants).

Hanlin v Commissioner places the burden on the taxpayer to prove that two securities are not SI; however, it gives the taxpayer a clearer set of rules by which to accomplish this.

KEY REVENUE RULINGS

A number of key revenue rulings reference *Hanlin v Commissioner* and provide additional criteria by which to determine whether two securities are SI.

Revenue Ruling 1958-211

According to Revenue Ruling 1958-211, every debt instrument has some important characteristics that must be compared and contrasted in order to determine if two securities are SI. This ruling specifically considers two specific U.S. Treasury bonds with similar characteristics: U.S. Treasury 2 1/4 percent coupon (bearer) bonds maturing December 15, 1962, but callable on and after December 15, 1959, at par (face amount) and accrued interest and U.S. Treasury 2 1/4 percent registered bonds, of equal face (principal) amount, maturing June 15, 1962, but callable on and after June 15, 1959, at par and accrued interest.

This ruling ultimately concludes that they are in fact SI to one another. In addition, 1958-211 enhances *Hanlin v Commissioner* by introducing a new concept: "several material features considered together," which we will soon explore.

The ruling lays out a basic mechanism for comparing two debt instruments (probably applicable to other asset classes as well). Once the taxpayer has enumerated the various characteristics of the two instruments, two basic requirements must be met. First, there should be no substantial differences in any one of the material characteristics called out by the RR as pertinent to these two instruments. Second, the difference "in several material features considered together" should not cumulatively form a substantial difference. We will see an instance of when this second requirement is violated in RR 58-210, discussed below.

Revenue Ruling 58-211 states: "the fact that bonds" have "approximately the same market value … does not necessarily establish" that the bonds are SI, even though certain other factors (such as issuer, seniority and coupon) are identical. The text relies on the fact that large differences in maturity date can cause two bonds to *not* be SI. Specifically, the text states: "for that market situation can occur even if such respective series of bonds have substantially different maturity dates." That means that two bonds could *falsely* appear to be SI because of similar market pricing even though other factors (such as maturity date) differ substantially and therefore prevent the bonds in question from being SI. The text goes on to describe the effect of different market conditions on bonds with different maturities, which is why such maturity dates are salient.

Revenue Ruling 1958-211 calls out several important features of treasury bonds. However, since the ruling governs all types of bonds, it is clear many other features of bonds may need to be considered depending on the particulars of the bonds in question. For reference purposes, the following are some of the features called out by RR 58-211 and it can safely be assumed that the following features are material for all bonds when present:

- Price or Market Value (adjusted for size and denomination) where difference is not explained by factors listed below
- Issuer
- Maturity
- Interest Rate
- Optionality Schedules (such as call schedules)
- Debt Seniority (aka Security)

In the conclusion, we see the only key difference between the two bonds is whether or not they are bearer or registered. The ruling indicates that this is not a material difference.

Revenue Ruling 1958-210

Revenue Ruling 1958-210 explicitly singles out two different treasury bonds (each with the same coupon, issuer and *similar* maturity dates) as not being **SI** because of different tax and redemption properties. The two bonds in question are 2 ½ percent treasury bonds maturing in September of 1972 and December of 1972 respectively. Here is a simple case where "several material features considered together" constitute a material difference between the two bonds, making the two bonds **not** SI.

Revenue Ruling 1958-210, though sequentially prior to RR 1958-211 actually refers to RR 1958-211 in its text. For this reason, we can only discuss RR 1958-210 after discussing RR 1958-211. In addition to RR 1958-211, RR 1958-210 also heavily references Income Tax Ruling 1365 (I.T. 1365, C.B. I-1, 151 (1922))[2] in which a Second Liberty Loan Bond and a Fourth Liberty Loan Bond are deemed to *not* be SI. The reasoning in Income Tax Ruling 1365 is based on the two bonds having different market values and maturity dates.

Specifically, the text of RR 1958-210 clarifies the earlier Income Tax Ruling 1365 by stating "Important features of securities" for consideration of SI "include their earning power or interest rate; value of assets, tangible or intangible, or security;

[2] Income Tax Ruling 1365 (the predecessor to Revenue Rulings) was published in 1922. http://books.google.com/books?id=snHPAAAAMAAJ&pg=PA151

and conditions of retirement, or, in the case of bonds, maturity dates and earlier call provisions." Note that it does not *limit* consideration to these properties.

Ultimately, RR 1958-210 considers two factors that **do** differentiate the two different bonds in question. One of the bonds is redeemable for application to the taxpayer's tax obligation due from a deceased owner's estate. The other is not so applicable. Also, one bond is available for investment by commercial banks at the time the bonds were purchased and sold, and the other bond does not become so until 14 years later.

Of critical import here is that IRS states that the two factors when considered together make the bonds different enough so as not to qualify as SI. The IRS explicitly dodges making any conclusions about what would happen if only *one* of these two differences was present. This conclusion ties back to the language found in RR 1958-211, in which "differences in several material features considered together" can stop two securities from being considered SI.

We therefore conclude that the following two factors must be added to the above list of material features under RR 1958-211:

- Any redemption features
- Eligibility for investment by commercial banks

Also, both rulings address the following features, which are considered immaterial for determination of SI:

- Whether the bond is registered or bearer
- Denominations in which the bond is issued
- Payment schedule for coupons

Revenue Ruling 1959-44

According to this ruling, bonds of different local housing authorities, issued under agreement with the Federal Public Housing Administration (FPA), are not "substantially identical" securities within the meaning of section 1091 (http://www.law.cornell.edu/uscode/text/26/1091) of the Internal Revenue Code of 1954. Revenue Ruling 1959-44 expounds *Hanlin v Commissioner* by clarifying who the 'obligor' (or primary issuer) is when a debt instrument is issued by one entity but guaranteed by a second entity.

Based on this ruling, two bonds that might be otherwise SI will not be considered such if their issuers are different. In this particular case, the issuers of the two similar bonds are different, yet they are both back stopped by the federal government. This ruling tackles the obvious but rather complex question: who is the *primary obligor* of the bonds -- the local branch of the FPA or the U.S. government?

After closely examining the bonds in question, the IRS ruled "each of such authorities is a separate and distinct entity, independent of the others, and the primary obligor itself on the bonds involved issued by it." Hence, the issuer is different and hence the bonds are not SI. Revenue Ruling 1959-44 explicitly refers to *Hanlin v Commissioner* and makes a distinction from this case by pointing out that the ruling involved separate local authorities "with no secondary liability with respect to each other's bonds." This key phrase, combined with the decision that the U.S. Federal government is not the primary obligor of the bonds, clarifies that the issuers are different; hence the bonds in question are not SI.

Revenue Ruling 1960-195

According to this ruling, the Richmond-Petersburg Turnpike Authority 3.45 percent Revenue Bonds, new issue, and the Richmond-Petersburg Turnpike Authority 4.5 percent Revenue Bonds, additional issue, are not “substantially identical” securities within the meaning of section 1091, (http://www.law.cornell.edu/uscode/text/26/1091) of the Internal Revenue Code of 1954, because there is a substantial difference in the interest rates.

This ruling also references *Hanlin v Commissioner*. In this case, we have a single material difference in one of the salient features of the two bonds, the interest rate. The *Hanlin v Commissioner* case made it clear that the courts viewed a single material difference as sufficient enough to determine that two bonds are not SI.

One feature this ruling does not mention is yield. The cumulative effect of the rules discussed so far seems to imply that yield is not a relevant characteristic for the determination of SI. That being said, any two bonds that are determined to be SI (based on the characteristics that are considered salient) must have similar yields. Since in practice, bonds are traded on yield (and often duration and convexity) and not on interest, it is well possible that two bonds can be effectively identical from the bondholder’s perspective (because they have identical risk characteristics), but be ruled not SI due to large differences in interest rate.

Conversely, while large differences in yield can prevent two securities from being classified as SI, similar yields do not override differences in interest rate, since in this ruling, a substantial difference in the interest rates alone resulted in SI. This ruling represents a possible loophole in the rule for SI determination for bonds. We would like to point out that two bonds with similar yields can have radically different cash flows, which can lend some support to the determination that they are not SI. In addition, it is also worth noting that RR 58-210 ruled that a difference in coupon payment schedule as immaterial. Based on this, one could draw the logical conclusion that the size of the payment is important whereas small differences in the timing of the payment are not.

It can be noted that the ratio between the coupon rates of the two bonds (3.45% and 4.5%) is 0.77. It is possible that a practitioner might use this ratio as an indication of when two interest rates are sufficiently different so that the bonds are not to be considered SI. Of course, we cannot guess how the IRS would rule in a future case, so we are simply noting the value of the ratio and not recommending one way or the other as to how this ratio can or should be used.

Revenue Ruling 1976-346

U.S. Treasury 63/8 (7 ⅞) percent bonds maturing in 1982 and **not** redeemable at par with accrued interest for payment of estate taxes and U.S. Treasury 41/4 (10 ¼) percent bonds maturing in 1992 and redeemable at par with accrued interest for payment of estate taxes are not "substantially identical" securities within the meaning of the wash sales provisions.

This ruling draws upon the “differences in several material features considered together” logic from RR 1958-211 and cites differences in three factors: interest rate, maturity date and redemption characteristics. It does not clarify whether any of these factors alone are sufficient to demonstrate that the two bonds are not SI. However, the ratio of the interest rates is similar to the case in RR 1960-195 and therefore it would appear that at least within the characteristic of interest rates, this alone would be adequate to determine they are not SI. Separately, redemption factors alone were determined in RR 1958-210 to be sufficient to demonstrate that two bonds are not SI.

This ruling does not introduce any new guidelines on how to determine if two bonds are SI. However, it does cement the logic already postulated in *Hanlin v Commissioner* and RR 58-210 and RR 58-211. In RR 1960-95, the interest rates are 3.45 and 4.50 and the ratio of the two rates is 0.77. In this case, the ratio of the two interest rates, 7.875 and 10.25, is also around 0.77. So it is possible that this ratio or a smaller one, when combined with other sufficiently large differences in "material features" in two bonds would constitute an argument for why two bonds are not SI.

CONVERTIBLE BONDS & SI

CFR 1.1233-1(d) and RR 77-201

Here we discuss RR 77-201 and CFR 1.1233-1(d), two important sources of information on convertible securities. Although the summary of RR 77-201 does not mention convertible bonds, the body of the text ties its reasoning to CFR 1.1233-1(d) and discusses cases "where the preferred stock or **bonds** are convertible into common stock."

Excerpts from the two sources follows:

"[In] certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property." (CFR 1.1233-1(d))

"Convertible preferred stock that has the same voting rights as the common stock, is subject to the same dividend restrictions, sells at prices that do not vary significantly from the conversion ratio, and is unrestricted as to convertibility is, for purposes of the wash sale provisions, substantially identical to the common stock and is also considered an option to acquire such stock." (Rev. Ruling 77-201)

Based on both of these documents, a number of factors must be considered when determining whether a convertible security is substantially identical to common stock issued by the same entity. Here is the list of some of the factors that would be used for the determination of a SI relationship between a convertible security and its underlier.

- The convertible may be converted into common stock.
- The convertible has the same voting rights as the common stock.
- The convertible is subject to the same dividend restrictions as the common stock.
- The two securities trade at prices whose ratio does not vary significantly from the conversion ratio.
- The convertible is unrestricted as to convertibility.

If all of these factors are determined to be present (and there are no additional factors to the contrary), then a convertible security is SI to its underlier. However, the lack of any of these factors does not necessarily prevent an SI relationship between the security and its underlier.

Please note that a later part of RR 77-201 states that when there are no convertibility restrictions, the convertible is considered an option to acquire the underlying stock, which by itself triggers the wash sale rule. In other words, in cases where the convertible is not SI to the underlier, it may still serve as an options contract and therefore trigger the wash sale rule solely because of section 1091.

The reader should note that many convertible bonds do restrict conversion during their first several years of issuance. This would seem to imply that they cannot be SI to their underlier until that point in time where conversion is permitted by the security.

CFR § 1.148-4(B)(2)(II)

Many years after *Hanlin v Commissioner*, the IRS added text to the CFR to summarize its thinking on the nature of SI with respect to bonds. In this section of the CFR, dealing with bond yields, the language reads: “Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same.” However, due to RR 58-210, it is always important to consider all material features (such as redemption provisions and restrictions) as well as the three factors called out in the above quote. Although CFR 1.148 has nothing to do with wash sales, it is generally accepted that all clarifications to the meaning of SI affect all rules that use this term.

CONCLUSION

The concept of “Substantially Identical” was introduced into the text of the Revenue Act of 1921 and became intrinsic to the calculation of wash sales and capital gains. From 1921 to 1939 it is not clear how the concept of SI was applied to debt securities. The 1939 *Hanlin v Commissioner* court case provided basic criteria to be used to determine whether two bonds were SI or not.

Since 1939, many major rulings have referred to *Hanlin v Commissioner* and several have further elaborated on this case and adapted the court’s paradigm to apply to new, real-world cases. Importantly, we saw how having two different bond issuers whose credit is backed up by an identical securitor are not considered to have the same issuer. We have also seen how redemption factors are considered to be a key feature in the determination of SI. And lastly, we have seen how the concept of “differences in several material features considered together” is invoked repeatedly by the IRS.

As more complex cases crop up with newer debt instruments, we expect this evolution will only continue. To our knowledge we are unaware of any revenue rulings on Swaps, FRA’s, Bank Debt or Commercial Paper. And since new security classes seem to spring into existence every day, we expect the IRS will be busy continuing to evolve the debt SI paradigm.

In this paper, we have introduced most of the currently extant rules for the paradigm initiated by *Hanlin v Commissioner*. We hope this discussion will prove useful to a practitioner struggling with this knotty problem.

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