Wash Sale Concerns for Mutual Funds & DRIPs

7/18/2011

White Paper

The Emergency Economic Stabilization Act of 2008 requires that wash sales be considered for calculating the cost basis to be reported on 1099(b)s for mutual fund securities and dividend reinvestment plans that were acquired on or after January 1st, 2012. This paper discusses some of the critical issues involved in meeting this reporting requirement and includes examples of complex wash sale scenarios.

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Contents

MAJOR WASH SALE ISSUES FOR MUTUAL FUNDS & DRIPs

- Reinvested Dividends
- Nondividend Distributions
- Transfers
- Short-Term to Long-Term Classification
- Share Class Transformation
- Average Cost Basis Method (single-category)
- Average Cost Basis Method (double-category)
- Selection of Tax lots

Reinvested Dividends

Many mutual funds use Dividend Reinvestment Plans (DRIPs) for their disbursements. When a mutual fund pays out a dividend--capital gain or return of capital to an investor--this money is frequently used to automatically purchase more shares of the fund. These additional shares form a new tax lot and their cost basis is equal to the amount of the dividend used to purchase them. From a tax perspective, the investor is treated as receiving a cash payment and then reinvesting it to purchase dividends. In principle, this is simple. But, for wash sale calculations, this adds an additional layer of complexity because the additional tax lots created need to be accounted for before the wash sale rules for cost basis adjustments can be applied correctly. Moreover, the holding period of shares and date adjustments is also dependent on the creation of new tax lots. This is especially so with DRIPs; each set of reinvested dividends is associated with a different timestamp. Let's walk through an example.

Example Investment: PIMCO Total Return A

In this example, a position of 1,000 shares is held in PIMCO Total Return A shares. 500 shares are sold within 30 days of a DRIP Buy.

1. Buy 1,000 shares of PIMCO Total Return A at $10.88 on 2/28/2011
2. Sell 500 shares of PIMCO Total Return A at $10.68 on 3/3/2011
3. DRIP Buy 6.977 shares of PIMCO Total Return A at $10.75 on 3/8/2011

The preceding trades result in a wash sale since the 3rd buy (the replacement) occurred within 30 days of a sell, generating a loss. From this set of trades, the DRIP buy serves as the replacement transaction of 6.977 shares. Hence, not only must we expect an adjustment to cost basis for the DRIP buy, but, we must also see an adjustment to the holding period of the DRIP buy. Calculating the wash sale incurs a $0.20 loss per share for 6.977 replaced shares, giving us a disallowed loss of $1.40.

NONDIVIDEND DISTRIBUTIONS

In the Return of Capital (ROC) case, where there is no DRIP, a cash disbursement is made to the investor. This is usually because one of the component companies is the subject of a LBO (leveraged buy-out) or other corporate action. The input for a closing trade includes the cost basis and this is adjusted for the ROC. The cash disbursement reduces the cost basis to zero and the remaining distribution is listed as a capital gain. Two wash sales scenarios have been constructed to demonstrate Return of Capital transactions.

Example Investment: Fidelity US Bond Index Fund and JP Morgan US Real Estate A

In the first example, shares of the Fidelity US Bond Index Fund are purchased and we anticipate a $300 disallowed loss resulting from the wash sale.

1. Buy 1,000 shares of Fidelity US Bond Index Fund at $11.60 on 11/1/2010
2. Return of capital of $1.50 per share from Fidelity US Bond Index Fund on 11/15/2010
3. Sell 1,000 shares of Fidelity US Bond Index Fund at $9.80 on 11/30/2010
4. Buy 1,000 shares of Fidelity US Bond Index Fund at $9.95 on 12/4/2010

The Return of Capital reduces the basis of the shares bought on 11/1/2010. Hence, when the shares are sold at a loss on 11/30/2010, the loss that we would have seen without the Return of Capital isn't as large. The shares purchased on 12/4/2010 serve to replace the original shares.

In the second Return of Capital example below, we anticipate that no wash sale exists, since after accounting for Return of Capital, the investor did not realize a loss on the sale.

1. Buy 1,000 shares of JP Morgan US Real Estate A at $15.85 on 1/3/2011
2. Return of capital of $1.50 per share from JP Morgan US Real Estate A on 1/31/2011
3. Sell 1,000 shares of JP Morgan US Real Estate A at $15.05 on 2/10/2011
4. Buy 1,000 shares of JP Morgan US Real Estate A at $16.39 on 2/25/2011

As can be seen above, the Return of Capital actually caused the cost basis of the buy transaction on 1/3/2011 to be reduced such that, when it is sold, it actually generates a gain. Hence, the above sequence of transactions does not result in a wash sale.

TRANSFERS

Transfers out of an account require partial-year wash sales to be calculated before the shares can move. This is true for equities as well, but when reporting on mutual funds, this is a must-have as opposed to a nice-to-have. Adjustment information for transfers needs to be properly accounted for and accurately reported.

Example Investment: Vanguard 500 Index Investor

In this example, shares with a cost basis adjustment due to a wash sale are transferred.

1. Buy 10 shares of Vanguard 500 Index Investor at $111.28 on 04/29/2010
2. Sell 10 shares of Vanguard 500 Index Investor at $104.08 on 05/06/2010
3. Buy 10 shares of Vanguard 500 Index Investor at $100.68 on 05/28/2010
4. Transfer 10 shares of Vanguard 500 Index Investor on 06/09/2010 with adjusted cost basis of $107.88 and adjusted open date of 4/29/2010

In this example, the 10 shares of Vanguard 500 Index Investor that are purchased on 04/29/2010 are disposed of at a loss. Within the 30-day period (61-day window), replacement shares of Vanguard 500 Index Investor are purchased and this results in a wash sale. The original basis of the shares bought on 05/28/2010 is $100.68, but due to the adjustment of basis arising from the wash sale, it now has an adjusted basis of $107.88. Hence, the shares that are transferred from this account on 06/09/2010 should not only carefully note the original purchase information but the adjusted information on appropriate dates and bases as well.

SHORT-TERM TO LONG-TERM CLASSIFICATION

A fundamental consequence of the wash sale rule is that the holding period of investments is also adjusted in accordance with the tax code. Shares that are short-term and held for only a few days, but involved in a wash sale, can be classified as long-term in certain circumstances. This has tax implications and needs to be treated appropriately; shares that are held for a short-term period are taxed differently than those that are held for a long-term period.

Example Investment: Fidelity Contrafund

This is a multi-year wash sale scenario to illustrate the transformation in classification of the holding period of an investment.

1. Buy 100 shares of Fidelity Contrafund at $72.53 on 12/10/2008
2. Sell 100 shares of Fidelity Contrafund at $44.74 on 11/30/2009
3. Buy 100 shares of Fidelity Contrafund at $43.96 on 12/22/2009

Transaction 1 is the open trade of the wash sale. Transaction 2 is the closing trade of the wash sale. Transaction 3 is the replacement trade, with its adjusted open date set to 12/10/2008.

SHARE CLASS TRANSFORMATIONS

Share class transformations are a rare occurrence but must be tackled for mutual funds. Scenarios for full and partial transformations of share classes must be appropriately processed in order to report accurate basis adjustments in wash sales.

Example Investments: ABCDA, ABCDB

This example illustrates a simple share class transformation.

1. Buy 100 shares of ABCDA at $10.00 on 01/01/2010
2. Share Class Transformation of ABCDA →ABCDB on 01/10/2010

3. Sell 100 shares of ABCDB at $9.00 on 01/20/2010
4. Buy 100 shares of ABCDB at $11.00 on 01/26/2010

After 100 shares of ABCDA are bought on 01/01/2010, there is a share class transformation that converts the shares to ABCDB. ABCDB is then subsequently sold at a loss (since the cost is of ABCDA), and replacement shares for ABCDB are purchased within the wash sales window, causing a wash sale. $1.00 of disallowed loss per share is applied as adjustment to the 100 shares of ABCDB that is purchased as the replacement.

AVERAGE COST BASIS METHOD (SINGLE-CATEGORY)

The single-category averaging method is just one way to determine the basis of shares in a mutual fund. First In First Out (FIFO) and Identification are straightforward and the double-category averaging is similar in theory to the single-category averaging method. However, a slight distinction exists and will be discussed later. Essentially, in the single-category averaging method, the basis of all shares held in the mutual fund is divided by the total number of shares. This is the average basis. Furthermore, it must be noted that certain eligibility requirements must be met in order to elect this method for cost basis calculation of mutual fund shares.

Example Investment: AVGSC

This example walks through a mutual fund wash sale case that uses the single-category averaging method.

1. Buy 10 shares of AVGSC at $100.00 on 01/01/2010
2. Sell 10 shares of AVGSC at $ 90.00 on 01/10/2010
3. Buy 10 shares of AVGSC at $100.00 on 01/20/2010
4. Buy 10 shares of AVGSC at $98 on 01/26/2010
5. Sell 10 shares of AVGSC at $107.00 on 04/01/2010

The AVGSC shares were sold at a loss of $10/share on 01/10/2010. The buy purchased on 01/20/2010 serves to act as a replacement to the shares of AVGSC initially held, creating a wash sale. Moreover, the basis of the 10 AVGSC shares purchased on 01/20/2010 is adjusted by $10/share now making the basis $110.00. Another 10 shares of AVGSC are purchased on 01/26/2010 at $98.00 each, bringing the total basis of the shares to 10 x $98.00 + 10 x $110.00, which is $2080 or $104/share. On 04/01/2010, 10 shares are sold at $107.00. The shares purchased on 01/20/2010 are disposed of, since FIFO is used to determine which shares leave first. The cost basis of the shares that are disposed of is $104 x 10, which is $1040. This implies that the sell occurring on 04/01/2010 results in a gain of $3/share for 10 shares. What remains in this account are 10 shares with a cost basis of $104.00.

AVERAGE COST BASIS METHOD (DOUBLE-CATEGORY)

The double-category averaging method is just another way to determine the basis of shares in a mutual fund. The basic principle of basis calculation in this method is identical to the single-category method. However, different cost bases are calculated for long-term and short-term shares that are held. While disposing of shares, the choice can be made to either close from the long-term shares or the short-term shares. Accordingly, either the short-term average cost basis or the long-term average cost basis is used. It must be noted that certain eligibility requirements must be met in order to elect this method for cost basis calculation of mutual fund shares.

Example Investment: AVGDC

This example walks through a mutual fund wash sale case that uses the double-category averaging method.

1. Buy 10 shares of AVGDC at $100.00 on 01/01/2010
2. Buy 10 shares of AVGDC at $ 80.00 on 01/10/2010
3. Buy 10 shares of AVGDC at $160.00 on 01/20/2011
4. Buy 10 shares of AVGDC at $140.00 on 01/26/2011
5. Sell 10 shares of AVGDC at $70.00 on 01/28/2011

In order to calculate the average cost basis using the double-category method, the AVGDC shares are divided into short-term and long-term shares. Hence, the 20 AVGDC shares purchased in 2010 being held for more than a year are considered long-term shares and have an average cost basis of $90 for the lot of 20 shares. The 20 AVGDC shares bought in 2011 are the short-term shares with an average cost basis of $150 for the lot of 20 shares. Assuming the short-term shares are elected to be disposed of, the 10 shares sold on 01/28/2011 close the 10 shares bought on 01/20/2011, with an average basis of $150. Hence, the 10 AVGDC shares are sold at a loss of $80 per share. The Buy on 01/26/2011 is within the 61-day period and acts as the replacement transaction, giving rise to a wash sale with a disallowed loss of $800. Hence, the basis of the remaining short-term shares is adjusted from $150 to $230. As of 01/29/2011, there are 20 long-term AVGDC shares with an average cost basis of $90 and 10 short-term AVGDC shares with an average cost basis of $230. Please note that the shares considered short-term will become long-term if they are held for more than a year or, if the holding period of the short-term shares is adjusted as a result of an event, such as a wash sale.

SELECTION OF TAX LOTS

In order to comply with current cost basis reporting requirements, it is critical to be able to use tax lot information in order to select transactions that participate in wash sales. This enables only the selected tax lots to be processed for wash sale calculations based on IRS rulings. This approach enables tracking of tax lots created only after 2012 for the purposes of mutual funds for wash sales.

Example Investment: ABMRP

Based on the regulation as it stands, 01/01/2012 is the effective date after which wash sales and cost basis reporting is considered for purposes of reporting. This example demonstrates how a tax lot from before the period of concern has no effect on the wash sale.

1. Buy 100 shares of ABMRP at $10.53 on 06/15/2009
2. Sell 100 shares of ABMRP at $9.06 on 01/20/2012
3. Buy 100 shares of ABMRP at $8.44 on 01/26/2012

All the 100 shares of ABMRP that are bought on 06/15/2009 are sold at a loss on 01/20/2012. 100 shares of ABMRP are repurchased on 01/26/2012. Note that this is not considered a replacement transaction since we need to ignore tax lots prior to 01/01/2012. Hence, this situation does not produce a wash sale.

SUMMARY

This paper has examined a number of complex wash sale scenarios that impact Mutual Fund and DRIP cost basis reporting as required by the Emergency Economic Stabilization Act of 2008. At first glance, identifying a wash sale appears to be a simple process. However, several issues make correctly identifying and accurately reporting on wash sales complex and anything but straightforward.

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