Wash Sale Implications of Short Sales

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White Paper

There is a great deal of confusion in the industry relating to the proper wash sale treatment of short sales when positions are closed. The IRS tax code can be ambiguous on this matter. To help clarify these rules, this paper discusses three issues: (1) rules for the exact timing of events for realization of the loss and how to calculate the 61-day window for replacements, (2) interaction of boxed positions with the wash sales rules creating a special case we term 'Delivery Wash Sales,' and (3) complex interactions between section 1259 (constructive sales) and section 1091 (wash sales).

This paper can serve as a set of guidelines for field auditors who encounter these scenarios and it can also function as a set of rules to follow when building wash sale software.

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INTRODUCTION

Determining whether or not a short sale will result in a wash sale can be a highly complex and confusing process. Rules governing wash sales have existed since Congress passed the Revenue Act of 1921. However, the text introduced by that act did not address the impact of short sales on wash sales. In 1984, the addition of subsection 1091-E definitively allowed for the interactions of wash sales on short positions. Unfortunately, a literal reading of the text is insufficient to cover all cases. Therefore, multiple revenue rulings have been created to address many of the possible interaction scenarios. Pub 550 contains a simplified version of these revenue rulings. As a result, in order to have a comprehensive understanding of this topic, a practitioner in this space needs to be aware of the tax code, revenue rulings, Pub 550 and all of the ambiguities and contradictions contained therein.

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.

A wash sale is generally described as selling stock at a loss, and buying substantially identical securities within 30 days before or after the sale.

There are three consequences to executing a wash sale:

1. You are not allowed to claim the loss on your sale.
2. Your disallowed loss is added to the basis of the replacement security.
3. Your holding period for the replacement security includes the holding period of the security you sold.

THE ISSUES

Rules specific to short sales can cause confusion when analyzing portfolios for wash sales. The 1988 introduction of short sales rules for wash sales resulted in three specific complexities: (1) how to anchor the 61-day holding period. See “Holding Period Adjustment Methods for Wash Sales” on G2’s Cost Basis Advisory Page at www.g2systemsllc.com/costbasisadvisorypage for an in-depth discussion on this topic. (2) the concept of a “Delivery Wash Sale,” which is not specifically covered in the tax code but is delineated in Publication 550, and (3) interactions between section 1259 (constructive sales) and section 1091 (wash sales).

Holding Periods

Realizing gains or losses on short sales is not recognized until the closing of the position. Closing is defined as when property is delivered against the short position.

§ 1.1233-1(a) (1):

ONLY THEN IS THE REALIZED GAIN OR LOSS CALCULATED.

Deciding which dates to use to calculate the 61-day holding period is not at all straightforward. Historically, there’s been a debate regarding whether or not realized gains or losses on short sales should be recognized if identical shares are held long, also referred to as a boxed position. However, it is now common practice that a realized loss is not realized until the long shares are delivered against the short to close the position altogether (commonly referred to as a “pair-off”).

Using Publication 550 as a guide to determine the dates on which to calculate the 61-day window becomes problematic. One example of this is when an investor completes a short sale via a pair-off and then executes a subsequent cover short transaction. This transaction results in different dates with which to use to calculate the 61-day period. In the pair-off scenario, the effective date of the pair-off (the date on which the long position is delivered against the short position) is the date on which to enter the 61-day

calculation. However, if a short sale is completed using a cover short transaction, the effective date on which to calculate the 61-day wash sales period is the delivery date of the stock used to close the short position — or the Settlement Date of the cover short trade. These nuances can affect the accurate calculation of wash sales and deserve special attention during the annual analysis process.

Delivery Wash Sales

There are specific revenue rulings that were created to prohibit the use of boxed positions to cheat the wash sale rule. These rulings are summarized in Pub 550. Before these revenue rulings were enacted, a taxpayer could do the following:

Buy Stock A. Some time passes. Stock A shows an unrealized loss. The taxpayer wishes to take the loss but keep the position. However if they sell the stock at a loss and buy it right back, they get a wash sale. So instead of selling it, they box it, and buy another position long. After 30 days go by, they pair off the box at a loss and bang—a totally legitimate loss results.

IRS Publication 550 states the following:

*"**SHORT SALES.** THE WASH SALE RULES APPLY TO A LOSS REALIZED ON A SHORT SALE IF YOU SELL, OR ENTER INTO ANOTHER SHORT SALE OF, SUBSTANTIALLY IDENTICAL STOCK OR SECURITIES WITHIN A PERIOD BEGINNING 30 DAYS BEFORE THE DATE THE SHORT SALE IS COMPLETE AND ENDING 30 DAYS AFTER THAT DATE.*

FOR PURPOSES OF THE WASH SALE RULES, A SHORT SALE IS CONSIDERED COMPLETE ON THE DATE THE SHORT SALE IS ENTERED INTO, IF:

ON THAT DATE, YOU OWN STOCK OR SECURITIES IDENTICAL TO THOSE SOLD SHORT (OR BY THAT DATE YOU ENTER INTO A CONTRACT OR OPTION TO ACQUIRE THAT STOCK OR THOSE SECURITIES), AND

YOU LATER DELIVER THE STOCK OR SECURITIES TO CLOSE THE SHORT SALE.

OTHERWISE, A SHORT SALE IS NOT CONSIDERED COMPLETE UNTIL THE PROPERTY IS DELIVERED TO CLOSE THE SALE. "

So Pub 550 was enhanced to close this loophole, but it had the unintended side effect of creating strange scenarios. For instance, an investor buys a position long with one custodian. Later, he sells the position at another custodian via a short sale transaction (at a loss with respect to the original buy). He immediately pairs off the two custodial positions. The loss is considered a loss to the long side (as it should be). Unfortunately, a Delivery Wash Sale can result from this transaction. Should he sell short the same stock within the 30-day window, you have a wash sale even though, in effect, all you did was change your position from long to short.

Constructive Sales

According to IRS Publication 550:

*"**CONSTRUCTIVE SALE.** YOU ARE TREATED AS HAVING MADE A CONSTRUCTIVE SALE OF AN APPRECIATED FINANCIAL POSITION IF YOU:*

ENTER INTO A SHORT SALE OF THE SAME OR SUBSTANTIALLY IDENTICAL PROPERTY,

ENTER INTO AN OFFSETTING NOTIONAL PRINCIPAL CONTRACT RELATING TO THE SAME OR SUBSTANTIALLY IDENTICAL PROPERTY,

ENTER INTO A FUTURES OR FORWARD CONTRACT TO DELIVER THE SAME OR SUBSTANTIALLY IDENTICAL PROPERTY (INCLUDING A FORWARD CONTRACT THAT PROVIDES FOR CASH SETTLEMENT), OR

ACQUIRE THE SAME OR SUBSTANTIALLY IDENTICAL PROPERTY (IF THE APPRECIATED FINANCIAL POSITION IS A SHORT SALE, AN OFFSETTING NOTIONAL PRINCIPAL CONTRACT, OR A FUTURES OR FORWARD CONTRACT)."

All constructive sales involve a short position and there are many complex interactions between Sections 1259 (constructive sales) and 1091 (wash sales). This paper makes a cursory mention of one of the most problematic issues regarding these interactions. Our upcoming white paper, “Tax Code Section Interweaving,” explores this problem in further detail.

A buyer creates a constructive sale via a box, wherein the buy is leg 1 of the position. Section 1259 dictates that he must realize the implicit gain and mark a cost basis adjustment to that leg. Later, when he goes to sell the long leg, if the adjustment is large enough, a gain on that sale can be converted into a loss. Therefore, a new buy on the same security triggers a wash sale via section 1091.

EXAMPLES

The following examples highlight the nuances of wash sales implications for short sales:

Example 1

An investor Sells Short 100 shares on 1/3/2010 with proceeds of $500. On 4/30/2010, he subsequently Covers Short these 100 shares for $750 and realizes a loss of $250. This Cover settles on 5/5/2010 using T+3 and a weekend. The investor then Sells Short the same security on 6/2/2010.

Result: This results in a wash sale as the 2nd Short Sale counts as a replacement trade for the short position that was closed by the Cover on 4/30/2011. Although the new Short trade occurs a full 33 days after the trade date of the Cover, in the case of Short Sales, we use the settlement date and not the Trade date of the Cover for anchoring the 61-day window.

Example 2

A portfolio Buys Long 100 shares of ABC Corp on 1/1/2010 for $1,000. On 6/6/2010, the portfolio sells short 100 shares for proceeds of $900. The portfolio is now short against the box. A week and a half later, on 6/15/2010, the portfolio Buys Long another

100 shares for $950. On 9/30/2010, the portfolio delivers the long shares bought on 1/1/2010 to pair off the short position.

Result: The $100 loss from the pair off is deemed a wash sale because of the concept of a Delivery Wash Sale. This is because it appears the investor is trying to avoid a wash sale by creating a box. A replacement trade of substantially identical stock or securities has been made within a 30-day period of the short sale being complete. The short sale is deemed complete on the date of the trade (6/6/2010 — which basically brought it short against the box) and the subsequent replacement trade was completed on 6/15/2010 within the 30-day window.

Example 3

A portfolio buys a long position on 4/15/2010 of 100 shares for a cost of $750. On 4/30/2010, he subsequently Sells Short 100 shares for $500 and uses his long position to immediately pair off against the short effectively closing down the box and realizing a loss. The $250 loss is attributed to the long position. He then Sells Short 100 shares of the same security 10 days later on May 10th.

Result: A wash sale! $250 is disallowed. The Delivery Wash Sale concept makes no exception for scenarios where the rule was tripped accidentally. A Buy-Sell-Sell is now a wash sale.

Example 4

An investor Buys 100 shares on 1/3/2010 with a cost of $1000. On 1/4/2010, he then Sells Short 100 shares with proceeds of $1200. This is a constructive sale, recognizing a gain of $200, and adjusting the basis of the long lot to $1200. He then sells the long position on 9/1/2011 for $1100 proceeds showing a book gain of $100 but a tax ***loss*** of $100. Lastly, he Buys 100 shares on 9/2/2011 for a cost of $1200.

Result: This results in a wash sale since the lot sold on September 1 is considered to realize a loss. The short position taken on January 4th that created a box triggers this. Also note, the short position has a basis of $1200 (unchanged). The long position has an adjusted basis of $1300.

SUMMARY

Determining the wash sale implications of short positions is anything but straightforward. At first glance, they seem like a simple mirror of wash sales on long positions. However, as we have seen, this is not the case. Issues like holding periods, delivery wash sales and constructive sales make them different. This paper tries to clarify how to address these issues.

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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