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KPMG report: A primer on wash sale reporting in a volatile market

On the cusp of a potential recession, investors in stocks or securities need to be cautious about advice they use for harvesting losses if they plan on, or happen to repurchase substantially identical stock or securities close to a loss sale. Such tax loss harvesting strategies could trigger wash sale rules, even if the "repurchase" occurs before the sale. This is particularly problematic for unwary investors, since the information that brokers are required to report may be different from what investors need when determining whether they have run afoul of the rules.

Born under recession era policy, both the wash sale rules and wash sale reporting issues will likely rise in prominence again as investors face a volatile market. But what are the rules, why do they matter, and how can investors avoid inadvertently subjecting themselves to the impact of these rules?

Background

Wash sale rules were originally conceived to deter opportunists who may wish to take a loss for tax purposes without having changed their economic position. The basic premise is that an investor holding a stock or security would sell the investment once it had decreased in value and then repurchase the same, or substantially identical, stock or security. Without wash sale rules, the investors would be able to recognize a loss while re-investing in the same investment, effectively repositioning themselves for a gain as the investment regained value. As discussed below, early rules prevented the investor from recognizing any loss, but subsequent amendments allow investors to modify their basis so that the loss is not lost altogether, merely deferred.

Consider a simple example. An investor with $100 basis in ABC, Inc. stock sells the shares at $80, but then repurchases the same number of shares of ABC, Inc. stock within 30 days after the sale at $70. Without the wash sale rules, the investor would be entitled to a $20 loss, while maintaining the same position in ABC, Inc. stock. However, the wash sale rules disallow the loss, and instead require the investor to adjust the basis in their newly purchased shares upward, in this case to $90 (the loss of $20 is added to the repurchase price). Thus, the loss on the initial sale is deferred.

What makes this exercise particularly difficult is the discrepancy between the cost basis reporting rules (i.e., the information that brokers are required to provide to the IRS and to investors, and the information which investors actually need when preparing their personal taxes). Compounding the issue, recession concerns are fueling market volatility, meaning that investment decisions may inadvertently subject investors to wash sale rules.

A bit of history

Following World War I, during the depression of 1920-1921, there was significant political pressure to restore economic prosperity through limited government interference. Tasked with the job of cutting wartime revenue raisers, Secretary of the Treasury Andrew Mellon orchestrated the Revenue Act of 1921. Among the provisions of the Revenue Act of 1921 was a list of deductions allowed to individuals, including for losses not connected with a trade or business. Although the deductions allowed were largely similar to those allowed in the prior Revenue Act of 1918, there is the emergence of the anti-wash sale concept.

Although not listed as a "wash sale," section 214(a)(5) of the Revenue Act of 1921 provided:

> *No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed.*

As noted in **Senate Report 67-275** [PDF 5.6 MB] written by the Finance Committee prior to passage of the Act, the "deductions allowed for individuals" section was substantially the same as those allowed in a revenue act passed three years earlier aside from certain new provisions, including the disallowance "to prevent evasion through the medium of wash sales." Elsewhere, commenting on net losses, the report notes that amendments sought to "prevent taxpayers from taking colorable losses in wash sales and other fictitious exchanges." Thus, this early provision formed the backbone of the current wash sale disallowance rule found under section 1091, though the initial impact was to eliminate the deduction completely, rather than defer the loss through a basis adjustment. It is worth noting that the Senate Report described wash sales as involving "identical securities" rather than the more ambiguous "substantially identical property" as set forth in the Act.

Fast forwarding several decades to a relatively recent recession, the financial crisis of 2007-2008, (the "Great Recession"), Congress passed the first of several packages in an attempt to prevent the collapse of the financial system. The "Emergency Economic Stabilization Act of 2008" (EESA), created the Troubled Asset Relief Program (TARP) in order to purchase distressed assets from financial institutions. To help offset the $700 billion program, EESA contained a number of revenue raisers. Notably, EESA expanded section 6045 information reporting requirements by including new broker reporting rules for certain security transactions, beginning with certain transactions occurring after January 1, 2011.

Known as the "cost basis reporting requirements," the newly created rules required brokers to maintain the cost basis of covered securities and report not only the proceeds of the sale, but also the gain or loss and whether the gain or loss was long-term or short-term. The reporting framework included wash sale reporting rules but, for administrative and operational reasons, greatly simplified the information that brokers were required to report. Specifically, the cost basis reporting requirements require brokers to report wash sale basis adjustments only when the transactions occur in the "same account with respect to identical securities." As stated in the Joint Committee on Taxation (JCT) General Explanation of Tax Legislation Enacted in the 110th Congress (JCS-1-09), "Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number." Thus, Congress created a simplified reporting framework, which inevitably provides room for reporting oversight for the unwary investor.

The preamble to the **proposed regulations** noted that Treasury had received comments about requiring brokers to inform payees about discrepancies between the broker-reported basis and the basis that the payees must report on their income tax returns. However, Treasury simply noted that brokers can communicate additional detail, if desired.

The IRS updated **Form 1099-B** [PDF 44 KB] for wash sale information reporting beginning with the 2011 calendar year. As noted in the 2011 Form 1099-B **instructions** [PDF 153 KB], the form was rearranged, and new boxes were added to accommodate the expanded reporting requirements. Box 5 was updated to denote the amount

of loss disallowed due to a wash sale. In a 2014 update, the IRS rearranged **Form 1099-B** [PDF 111 KB] requiring payors to signify that the transaction included a wash sale with code "W" in Box 1f, followed by the disallowed amount in Box 1g. In 2016, the IRS settled on the current format, by eliminating the code and dedicating Box 1g to wash sale amounts. To date, the instructions have changed little for wash sales reporting since the original issuance.

Wash sale reporting requirements

The wash sale rules and cost basis reporting rules contain nuanced differences that further complicate taxpayer requirements. Revisiting the example above in this report, the investor purchased stock in ABC, Inc. in January at $100 per share and sells at $80 in March. The investor would initially be entitled to a short-term capital loss of $20 per share. If the investor purchases the same stock in the same account at $70 within 30 days before or after the sale, then the investor is no longer entitled to the loss. Under the section 1091 rules, the loss is disallowed and is essentially added to the basis of the newly purchased stock, increasing the basis up to $90. The adjustment to basis on the replacement shares is intended to allow the investor to potentially recognize the benefit of the deferred loss at a later time. Note that the "30 days before or after" the sale effectively creates a 61-day period which the investor will need to review. The reporting rules under section 6045 track easily under this simplified fact pattern, as the broker handling the transactions must provide the investor with information noting the disallowed wash sale loss on Form 1099-B, Box 1g.

However, the broker reporting / investor reporting symmetry breaks down as variables are added. The section 6045 rules specify that reporting by a broker is only required if the transactions occur in the same account. Conversely, wash sales may occur, and losses may be disallowed for a taxpayer, not only when occurring across brokerage accounts, but even across investment account types. As noted in **Rev. Rul. 2008-5** [PDF 12 KB] an individual may be susceptible to wash sale issues even when selling securities in a standard brokerage account and subsequently repurchasing them in an individual retirement account (IRA) or Roth IRA. As wash sale reporting by a broker is not required for such transactions, the investor may not be aware that the transactions fell under the wash sale rules.

Further complicating matters, section 1091 notes that wash sale loss disallowance is triggered when the repurchase involves "substantially identical stock or securities." As previously noted, the ambiguous term that has been a part of wash sale rules since 1921 was not included in the original Senate Report, nor are "substantially identical" repurchases required to be reported under the section 6045 broker reporting requirements. Thus, brokers are not asked to determine whether another stock or security is "substantially identical" and investors are left to their own means to determine whether they have crossed the line.

The "substantially identical" issue has been the subject of decades of cases, papers, and subsequent guidance, much of which has simply led to greater confusion. Reg. section 1.1233-1(d)(1), cross referencing section 1091, mentions that stock of separate companies typically would not be considered substantially identical, except certain situations such as reorganizations. Alternatively, bonds or preferred stock would not qualify, except certain situations such as convertible stock. While this provides a relatively simple analysis for individual stocks, it gets a bit trickier when looking at mutual funds and exchange-traded funds (ETFs), specifically because the IRS has yet to make a determination on whether funds from separate companies tracking the same index of stocks will be considered substantially identical. For example, could a fairly pedestrian disposition of SPY, an index tracking the S&P 500 largest companies, at a loss and a repurchase of VOO, a Vanguard ETF tracking the same companies, trigger a wash sale?

The analysis gets significantly more complicated when reviewing more sophisticated financial instruments. For example, GCM 38285 (a 1980 General Counsel Memorandum providing guidance on a proposed revenue ruling) determined that the repurchase of a call option constituted a wash sale when the call options were made for the same underlying stock and the same expiration date, but with different strike prices. However, in the analysis, the guidance in the GCM provides that "two call options might be considered somewhat dissimilar investments if the exercise price of one of the options is significantly higher than the current price of the underlying stock." This unsatisfying answer thus fails to clarify when a simple call option repurchase would qualify as a wash sale, let alone the host of derivatives that exist today.

KPMG observation

As illustrated above, wash sale rules can be vague and complicated. Luckily for brokers, the simplified reporting requirements mean that brokers may, but are not required to, report all loss disallowed under section 1091. Specifically, the IRS noted in the Form 1099-B instructions that brokers are not required to report disallowed losses when the transactions occur in separate accounts (as noted above), even if maintained by the same broker. The instructions also exclude broker reporting if the security is transferred out to another account or into the current account before the wash sale transaction.

Thus, wash sale issues can be extremely complex. During this current period of volatility, investors need to be particularly alert when navigating loss mitigation strategies. As noted in this report, the substantially identical issue can be difficult for average traders pursuing banal transactions, as the IRS has yet to make a determination on whether ETFs tracking the same index of stocks will qualify. Switching funds to secure lower expense ratios or performing multiple transactions to capture stocks at recent lows may subject the unwary to unexpected tax bills and potential penalties.

Furthermore, the simplified broker reporting rules outlined above mean that there may be a gap between information appearing on a Form 1099-B and information that taxpayers may need to comply with their own tax return filing. Investors may need to review each transaction for timing and pricing across accounts and determine whether any dispositions resulting in losses may be matched with replacement shares within the 61-day wash sale window, and whether the securities could be considered substantially identical. This analysis may be required even though a Form 1099-B or composite statement is being provided by the investor's broker.

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