



Washing Out a Loss—IRS Rules on IRA's Relationship to §1091  
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## **IRS Discusses Wash Sales and IRAs**

A topic of conversation that has come up on a number of online tax discussion forums I've participated in over the years has involved the tax implications of the following strategy:

The taxpayer wants to "harvest" a loss on a security that he has, but he believes it is going to come back and may do so in the near future, so he really doesn't want to dump the security for good, nor stay away from purchasing the security for the 30 days before and after his sale, which §1091 generally would require. So the taxpayer decides to have his IRA account purchase the identical security at the same time he disposes of the security in question from his taxable account.

Section 1091(a) provides:

(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. For purposes of this section, the term "stock or securities" shall, except as provided in regulations, include contracts or options to acquire or sell stock or securities.

Some practitioners argued that since the IRA is not the taxpayer, the acquisition of shares by the IRA does not trigger the §1091 disallowance of the loss. So while the taxpayer economically was protected from losing out on a subsequent increase in price, the law simply fell short since §1091 had no provision in it addressing related parties of any sort, let alone IRAs.

They also note that §1091(d) provides a method to make the taxpayer whole that would not work if, in fact, the taxpayer were no longer the owner of the securities:

(d) Unadjusted basis in case of wash sale of stock

If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

However, the IRS had indicated in Publication 550 that they felt there was a "related party" rule for wash sales. That publication provides:

**Indirect transactions.** You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

But, of course, that was merely a publication, and we are all used to the mantra found in many Tax Court decisions that the publications are not authoritative.

## Revenue Ruling 2008-5

The IRS decided to remedy that oversight with Revenue Ruling 2008-5, released this week. In that ruling the IRS gave us the following fact pattern:

A, an individual, owns 100 shares of X Company stock with a basis of \$1,000. On December 20, 2007, A sells the 100 shares of X Company stock for \$600 (the "Sale").

On December 21, 2007, A causes an individual retirement account (within the meaning of § 408) or a Roth IRA (within the meaning of § 408A), established for the exclusive benefit of A or A's beneficiaries, to purchase 100 shares of X Company stock for its then fair market value (the "Purchase").

A executes the Sale and the Purchase with different, unrelated market participants.

A is not a dealer in stock or securities.

Getting to the end of the story first, the IRS concludes the ruling as follows:

The loss on the Sale of stock is disallowed under § 1091. A's basis in the individual retirement account or Roth IRA is not increased by virtue of § 1091(d). This ruling does not address any issues other than those specifically addressed herein. In particular, this ruling does not address (and no inference should be drawn with respect to) any issue arising under § 4975.

The last sentence is a bit interesting, since if there is a §4975 issue that would be rather disastrous for the taxpayer. However, I suspect that line was put in primarily because the IRS was concerned that someone might try to argue "linkage" and that it seemed unlikely the IRS could get a court to buy that such a sale would be a prohibited transaction under §4975.

If that is the case, then it would seem the IRS is aiming more at the "spirit" of §1091 and that this transaction certainly appears to violate that—the taxpayer is arguably in the same economic position as if he had not sold the stock.

## IRS Support

The IRS recites the basic relevant provisions of the IRC for this transaction, but their main support claimed for invoking §1091 is the case of *Security First National Bank of Los Angeles*, 28 BTA 289. The IRS summary of that case indicates that:

...the taxpayer sold bonds (at a market price) to a corporation of which the taxpayer was the sole shareholder. On the same day, in exchange for land, the corporation transferred the same bonds at the same price to a trust over which the taxpayer had absolute dominion and control.

It is useful to note that the Court, in this case, was concerned that the particular trust and its structure (due to which all income of the trust was taxed back to the grantor—and this was prior to the statutory grantor trust rules) and that he could easily reconstitute title in himself (something not arguably so easy in the IRA context).

However, the IRS is really interested in the following portion of the opinion:

The [taxpayer] did not personally reacquire substantially identical property and, strictly construed, the language of section 214(a)(5), above referred to, might not apply. However, the rule of strict construction should not be unduly pressed to permit easy evasion of a taxing statute. *Carbon Steel Co. v. Lewellyn*, 251 U.S. 501. Unless the respondent is right, a trust like this one could be used deliberately to accomplish the very thing which Congress intended to frustrate. . . . Although title to the bonds was acquired by the trust, actual command over the property was still in the [taxpayer]. . . . The difference between acquisition by him personally and acquisition by the trust amounts only to a refinement of title and may be disregarded so far as section 214(a)(5) is concerned.

The IRS concern is with the intent—and, clearly, when this transaction is discussed the intent is to flush out the loss for tax purposes while still allowing the taxpayer to gain economically should the value rise during what would otherwise be the period during which the taxpayer would have to sit on the sidelines and not hold this security.

Personally, I find the second case the IRS references (*Shoenberg v. Commissioner*, 77 F. 2d 446) from the 6<sup>th</sup> Circuit to be more persuasive based on the facts of the case. In that case, a taxpayer had a broker simultaneously sell securities he held personally to trigger a loss, and then reacquire those same shares in a corporation owned 70% by the taxpayer, with the remaining interest held by the taxpayer's mother.

That court held directly on the issue of whether the fact these were separate entities for tax purposes negated the wash sale rules. The 6<sup>th</sup> Circuit held:

It is argued that the Investment Company and the taxpayer are separate entities and must be considered so here. Granting that they were, the domination of the company by the taxpayer was complete and in this transaction it was no more, in effect and substance, than his alter ego.

The Court also considered that it was important that this was clearly a plan to work around the wash sale rules, noting:

Examining this entire transaction, it is clear that this sale by taxpayer was

merely part of plan by which he hoped to create a tax deductible loss without any real change in his position. At the times he directed the broker to sell particular stocks, he also gave instructions to purchase identical stocks for the Globe Investment Company. Just over the thirty-day period of the statute, he purchased these same stocks from the Globe. He had complete dominion over the Globe as to such purchase by it, as to its retention of the stock for resale to him and as to such sale by it to him. For all practical purposes, he used the Globe as an agency for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss. That these actions by the Globe and his use of the Globe was a part of the plan which included sale by him is clear. The plan was an entirety and existed at the time of the sale by him. It was fully carried through. He was no poorer when the plan was executed than he had been before the sales by him, except for the brokerage commissions. He suffered no real loss, but solely a paper one which could be shown only by considering one part of an entire plan and transaction. The entire plan was devised for the purpose of showing such loss. Its results must be judged as an entirety.

The court held that the wash sales rules in the version of the IRC current at that time served to simplify the disallowance of losses without requiring that a plan be shown, but that if such a plan was found a loss could nevertheless still be disallowed—the wash sale provision did not establish an absolute bright line where if we just moved the clearly violating transfer more than 30 days into the future all is well if the taxpayer truly faces no economic exposure while waiting for the 30 days to elapse.

## **Is the IRS Right?**

Ultimately, the final question is whether the IRS is justified in this position—that is, can the IRS look beyond the strict formal provisions of §1091 which serves merely as an absolute bar and still end up with same result if a taxpayer engages in a planned transaction that does not directly trip the requirements of §1091, but seems rigged to accomplish the very goal that provision was meant to block?

And, if so, does the purchase in an IRA truly put the taxpayer in the same economic position? One factor that would seem to go against the IRS is that the taxpayer has taken an asset that would have generated capital gain if it appreciated and converted any appreciation that comes later into ordinary income—which may be argued to be a fundamental change in the economics of the situation.

That said, though, the smell of these transactions has always been troubling, and it's not difficult to see a court going along with the view that these transactions are entered into specifically to force the recognition of paper losses—especially since, in many cases, the idea is presented to the taxpayer in specifically those terms. That is, the taxpayer will get

a current tax deduction while being protected from losing out on future appreciation in the security.

Given the new provisions of §6694 effective for 2007 returns, it's also important to consider that if a position is taken that is contrary to this Revenue Ruling, that may create exposure both to the penalty under §6694(a) and the more serious penalty under §6694(b).

For §6694(a), the question becomes whether a position contrary to the Revenue Ruling meets the "more likely than not" standard considering the relevant authorities if the position is not disclosed. That, frankly, would appear to be a difficult hurdle to clear given that this Revenue Ruling is just about the only direct authority that exists. While clearly it's possible for a Revenue Ruling to be held to be in error (just look at the telephone excise tax issue), a preparer is going to need to assemble his or her own contrary authority.

The next issue is whether such a position can meet the "reasonable basis" standard. That is the minimum required for disclosed positions to avoid a §6694(a) penalty. That standard is defined at Reg. §1.6662-3(b)(3) as follows:

(3) Reasonable basis.

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in section 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in section 1.6662-4(d)(2). (See section 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in section 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

So even with an 8275, a preparer will need to be ready to bring forth his/her own persuasive authorities.

Finally, under Reg. §1.6694-3(f) a Revenue Ruling is defined as part of the "rules or regulations" for which reckless or intentional disregard can trigger the §6694(b) penalty. Under current Reg. §1.6694-3(c)(2), the penalty is avoided for disclosed positions that are not frivolous and, for Revenue Rulings, even for undisclosed positions that meet the

realistic possibility standard (the one in three rule). However, note that it is very possible when the IRS gets around to updating the regulations in light the recent changes to §6694 that these standards could be changed—since they now agree with what was the *prior* level of authority needed for §6694(a). If that were to be true, then when taking a position contrary to a Revenue Ruling, you would have to meet the more likely than not standard if not disclosed and the reasonable basis standard for disclosed positions.

As a practical matter, given that many of us considered this a “shaky” position in the past even before an IRS ruling, I suspect that most preparers will insist on disclosure if a client wants to claim this loss under a theory that the regulation is invalid. We may see some of that, since this ruling has come out just before year end—and clients may end up entering into these transactions without being aware that the IRS has now come down with their view on this issue—and may have received advice from other advisers that this was a good tax strategy.