

Notice 2009-17

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Internal Revenue Service
CC:PA:LPD:PR (Notice 2009-17)
Room 5203
P.O. Box 7604
Ben Franklin Station,
Washington, DC 20044

Re: Basis reporting by brokers

Ladies and Gentlemen:

This communication responds to the request for comments on broker reporting of basis in Notice 2009-17. It is prepared from the unique perspective of an author and publisher of books and a website designed to explain to the general public, as well as to investment professionals and tax professionals, how the tax laws apply to investments. These explanations have generated extensive feedback, including over 70,000 messages posted on a message board maintained for the website, from individuals facing these issues in the real world. The author of these comments has sometimes acted as an attorney or consultant on matters related to the issues discussed below, but is not representing any client in connection with this submission.

These comments are not comprehensive but instead focus on two particular areas where important details may have escaped the attention of others offering comments. First, the comments address issues relating to share identification and the FIFO rule that applies when shares are not identified. And second, the comments discuss a variety of issues relating to the wash sale rule.

Identification

An investor who has purchased shares of a particular stock on different dates or at different prices and subsequently sells some but not all of those shares will have different results depending on the lot from which shares are sold. The tax regulations currently permit the taxpayer to identify the lot at the time of the sale, and provide a default "FIFO" rule to cover situations where the taxpayer fails to identify the shares. Changes or clarifications would be helpful for both the identification rule and the FIFO rule.

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Justification for identification rule

As a preliminary matter, it may be helpful to review why we have an identification rule. I am not aware of any current effort to do away with the rule, but in the past some have suggested it should be eliminated. Briefly stated, the objection was that the economic consequences when selling shares from one lot are precisely the same as when selling from another lot, so taxpayers should not be able to obtain a tax advantage by choosing one lot over another.

Eliminating the identification rule, however, would introduce inefficiency. To see this, imagine that I hold a highly appreciated investment in shares of XYZ, and I intend to hold these shares indefinitely. I am considering how to invest additional funds on a temporary basis, and my choice comes down to XYZ and another stock. My preference is for XYZ, but the tax law will interfere with that choice if I cannot use the identification rule when selling the shares purchased for the temporary investment, as I would be treated as selling highly appreciated shares from my permanent holdings. Note that the identification rule more accurately reflects the economic reality that I made an additional, temporary investment.

The identification rule can also be seen as providing fairness between taxpayers. If an opportunity arises to profit from a temporary investment in shares of XYZ, an investor holding appreciated shares in the stock would face adverse tax consequences from that temporary investment, while another investor with no prior investment in that stock would have no such concern. Someone holding appreciated shares should not be at a disadvantage in making subsequent investment decisions.

Retroactive change in identification

Item 15 in Notice 2009-17 asks whether customers, after a sale, may identify or change the identification of specific stock sold and, if so, for what period of time or by what deadline. As a general principle, permitting taxpayers to use hindsight in selecting the shares sold in a particular transaction is inconsistent with the purposes of the identification rule. The potential disadvantages described above would turn to potential advantages. I might, for example, hold shares with a small short-term gain and others with a large long-term gain. At the time I sell a portion of this holding I may not know which choice will produce a better tax result, something that may become clear months later. The opportunity to make this choice after gaining a clearer picture of my trading results for the year would place me at an unfair advantage over someone whose holdings are similar to mine but include shares of two different stocks rather than two lots of the same stock. The current requirement for an identification "at the time of the sale or transfer" (Treas. Reg. § 1.1012-1(c)(3)(a)) is consistent with this notion.

Notwithstanding this general principle, it would be reasonable to accommodate identifications made shortly after the trade. In some situations the precise timing of a trade may be critical, and an investor may not have time to review holdings and select the lot from which she wishes to sell before triggering a sale. The rules should permit identifications made or changed after the fact provided they are locked in within a short period, such as by the end of the trading day following the date of the sale.

Brokers might be permitted but not required to make these retroactive changes available to their customers.

Method of identification

The current regulations provide a two-step process for identifying shares left in custody of a broker or other agent. First, the taxpayer must specify to the broker, at the time of the sale or transfer, the particular shares to be sold or transferred, and second, "within a reasonable time thereafter," the broker must set forth confirmation of the specification "in a written document."

We have heard from taxpayers who had difficulty obtaining cooperation from brokers that misunderstand their role in the process, believing they would have a further obligation to ensure somehow that the proper shares were transferred. The regulation says it does not matter which shares are actually delivered if an identification as describe above is made.

The first step in the process, in which the taxpayer "specifies" the shares to the broker, appears to be quite flexible. Apparently the specification can be provided orally, for example. Although there is no specific guidance on this point, it is understood that a standing instruction with the broker, for example, to sell the shares with the highest basis in any situation where identification would make a difference, complies with the first step even though there is no separate communication literally made "at the time of the sale or transfer."

The requirement of confirmation "in a written document" appears to be designed to create a paper trail that can be used to confirm that the taxpayer in fact made an identification contemporaneous with the sale. Today's technology renders this requirement obsolete. The second requirement should be satisfied if the broker maintains electronic records that can be used to document identifications made by its customers.

FIFO rule

The FIFO rule that acts as a default when identification is not made should be clarified. The rule says the sale or transfer "shall be charged against the earliest of such lots purchased or acquired." The application of this rule is ambiguous in some situations. Consider a taxpayer who has acquired two 100-share lots of a particular stock on different dates and at different prices. After a 2-for-1 stock split she holds 400 shares, and sells 200 without identifying the shares. Has she sold the first 100 shares, together with the split shares acquired as a result of holding those shares? Or has she sold 100 shares from each of the first two lots, leaving her with the 200 shares that were acquired later as a result of the split? The expected result in this situation would be the first one, although the second one is more in keeping with the literal language of the regulation. The rule should be clarified to apply based on the date measuring the holding period rather than the date the shares were acquired.

Application of FIFO and identification by account

A taxpayer may hold multiple lots of the same stock in different investment accounts. The FIFO and identification rules are intended to disambiguate a situation where it is unclear which of two or more lots of stock were sold, and no ambiguity exists in a situation where a taxpayer sells shares held in one account while retaining shares held in another. No purpose is served by global application of the FIFO rule or the accompanying identification rule. As a result, even before we had statutory language specifying that the new reporting rules are to be applied on an account-by-account basis it was generally understood that the FIFO rule does not operate across accounts. Indeed, it is almost amusingly absurd to imagine a taxpayer selling shares in an account held at one brokerage firm attempting to identify the shares as being from an account held at another brokerage firm. Nevertheless, the question of cross-account application of the FIFO rule occasionally arises, and it would be helpful to make it explicit, not just as a matter of reporting by brokers but as a matter of substantive law, that these rules do not apply across accounts.

The wash sale rule

Some of the comments below advocate interpretations designed to make the wash sale rule operate more precisely in accordance with its purpose. Generally a taxpayer has a reportable capital gain or loss only after a realization event, typically a sale. A sale may lack economic significance if the taxpayer replaces the shares that were sold in a purchase that occurs within a short period before or after the sale. The wash sale rule protects the integrity of the realization requirement by preventing taxpayers from claiming loss deductions when sales lack economic significance.

Wash sales and equity compensation

Taxpayers working for companies that have publicly traded stock may receive compensation in the form of stock or options. Generally an individual receiving such compensation does not control the timing, form or size of the award. Therefore, an acquisition of stock as a result of an award of equity compensation does not deprive a contemporaneous sale of economic significance. For example, if I sell 100 shares of XYZ at a loss and receive an award of 100 shares of XYZ the next day, the combination of these two events leave my investment position in XYZ unchanged. However, the sale of 100 shares has economic significance because my investment position would have increased by 100 shares without this sale. I did not acquire 100 shares for the purpose of replacing shares sold at a loss; the acquisition would have occurred without regard to my decision to sell shares. There is no reason to apply the wash sale rule in this situation.

The Internal Revenue Service has ruled (Rev. Rul. 73-329) that the wash sale rule applies in a situation where a taxpayer sells stock at a loss and, within the wash sale period, receives stock as a form of equity compensation. (The ruling does not address issues relating to vesting.) The validity of the ruling is questionable, as the law (IRC § 1091(a)) specifies that the wash sale rule applies when replacement securities are acquired "by purchase or by an exchange on which the entire amount of gain or loss was recognized by law." Plainly that is not the case when shares are acquired as equity

compensation. The ruling's argument that the stock award "is the equivalent of a purchase or an exchange" is specious. This ruling is contrary to both the language and the purpose of the wash sale rule, and should be withdrawn.

Compensatory option awards present different issues. A taxpayer receiving such an award may fairly be said to have "entered into a contract or option" to acquire replacement securities (IRC § 1091(a)), and of course a taxpayer who exercises such an option has acquired the shares by purchase. The Service has ruled (Rev. Rul. 56-452) that a wash sale may be triggered by the grant of a compensatory option. In addition, the ruling says that if the grant of an option was not an event that triggered a wash sale, the exercise of the option (occurring within the wash sale period before or after a sale of stock at a loss) will be considered a triggering event. Although this ruling falls within the literal language of the statute, it does not effectuate the purpose of the wash sale rule. The receipt of a compensatory stock option does not alter the economic significance of a contemporaneous sale of stock. The same is true of the exercise of a compensatory stock option. Although this is an event within the control of the taxpayer, it merely converts an existing economic interest in the stock from one form to another. This ruling also is contrary to the purpose of the wash sale rule, and should be replaced with guidance providing that the grant or exercise of a compensatory option will not trigger the wash sale rule.

Qualified employee stock purchase plans present these issues in a different context. By law (IRC § 423) these are plans that grant options, if they meet various requirements. In practice, they generally bear little resemblance to stock option plans, operating instead as an opportunity for employees to subscribe for the purchase of shares at regular intervals through payroll deduction. Because the purchase opportunities afforded by these plans are technically options, it is conceivable (although unlikely, one would hope) that the Service could argue that the mere opportunity to participate in the plan, without actual participation, is an event that triggers the wash sale rule. Yet the wash sale rule presents problems for participants in such plans even if it applies only to actual purchases. Many companies make purchases in such plans at three-month intervals. Given the 61-day span of the wash sale period, participants in such plans may be effectively blocked from selling shares on all but about eighty trading days of the year if they want to avoid triggering a wash sale. The manner in which these plans operate makes them unsuitable for use by a taxpayer seeking to avoid the economic reality of a sale entered into for the purpose of realizing a loss. Purchases made in connection with qualified employee stock purchase plans should not trigger the wash sale rule.

Some companies maintain stock purchase plans that are not designed to meet the requirements of section 423. These plans may or may not provide enough flexibility for participants to use them in a way that is contrary to the purpose of the wash sale rule, so it may be appropriate to exempt only purchases from qualified plans.

Wash sales and replacement shares

The wash sale rule is intended to offer a clear, mechanical rule that provides certainty as to when a purchase of securities will trigger disallowance of a loss from a sale of

substantially identical securities. Yet there are situations that fall within the literal language of the rule but do not fit within the purpose of the rule because it is clear the shares that were purchased do not replace the shares that were sold.

The simplest example is a taxpayer who buys shares and sells the same shares at a loss within 30 days. At the time of the sale, the taxpayer has made a purchase within the preceding 30 days, arguably bringing the sale within the literal language of the wash sale rule, yet it is understood that if these are the only relevant transactions, the rule will not apply because the shares sold are the same as the shares purchased.

A taxpayer might, however, buy 200 shares in a single purchase and sell only 100 of those shares at a loss within 30 days. Now the taxpayer is more clearly within the wash sale rule as he ends up holding shares that are identical to the ones sold at a loss and that were purchased within the wash sale period. Yet the shares could not possibly have been bought with the purpose of replacing the shares that were sold at a loss because all the shares were bought at the same time. The Service has recognized (Rev. Rul. 56-602) that the wash sale rule does not apply in this situation.

However, there are other situations where the same reasoning would apply but we do not have favorable guidance. For example, I might buy 100 shares of a particular stock, then buy another 100 ten days later, and then, another ten days later, use the identification rule to sell the second lot at a loss. The purpose of the wash sale rule is not implicated here. The shares I continue to hold after the sale were purchased within the wash sale period but could not possibly have been purchased to replace the shares sold at a loss because they were purchased before I owned the shares sold at a loss. The rules should specify that shares acquired before or at the same time as the shares sold at a loss were acquired are disregarded in applying the wash sale rule.

Wash sales and short sales

The proper application of the wash sale rule in connection with short sales is far from clear. Confusion stems in part from a failure to distinguish between a situation where a purchase of shares should trigger disallowance of a loss from a short sale (addressed, but not adequately, in Treas. Reg. § 1.1091-1(g)) and a situation where a *sale* of shares should trigger disallowance of such a loss (as provided in IRC § 1091(e) but never addressed in regulations or other guidance). For example, if I hold a short position in a stock without holding any shares of the stock, I have a bearish position in the stock. There is no reason to apply the wash sale rule if I switch to a bullish position by closing the short position at a loss and simultaneously buying additional shares. Guidance is needed to sort out these issues.

Wash sales and options

Guidance on the application of the wash sale rule to options is almost entirely lacking. Among the issues are situations where options may or may not be substantially identical where they differ in strike prices or expiration dates but are options on the same security. Additionally, while it is clear that the acquisition of an option can turn a sale of stock into a wash sale, it is less clear that the reverse is true.

Wash sales and holding period

The law provides (IRC § 1223(3)) that the holding period of shares that trigger a wash sale includes the holding period of the shares that were sold at a loss. We have no official guidance on how to apply this rule when there are gaps or overlaps in the actual holding period of the shares. The Service says, in Publication 550, that the replacement shares are to be treated as having a holding period beginning on the same date the holding period began for the shares sold at a loss (in other words, we are to ignore gaps and overlaps). This is surely the most sensible rule, but it would be helpful to have this rule expressed in official guidance.

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A request for further information concerning these comments would be welcome.

Very truly yours,

Kaye A. Thomas