

REG-101896-09



February 8, 2010

**LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH**

FEB 17 2010

CC:PA:LPD:PR (REG-101896-09)
Internal Revenue Service
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Clarification of wash sale rules for accurate broker reporting

To whom it may concern:

Silver Management Group, Inc. is an accomplished brokerage technology solution provider and professional services organization with decades of relevant experience in middle and back office investment services processing. Our current comments seek clarification of various aspects of the wash sale rules in order to promote correct and consistent application and thereby more accurate and useful broker reporting under proposed regulations REG-101896-09.

Although deceptively simple in appearance, the wash sale rules become quite complex when put into practice against real world investment activity. The number of individual wash sale adjustments resulting from just a relatively small number of purchases and sales of the same security can be quite large, particularly when a different quantity of shares is purchased or sold each time. Further, since current wash sale adjustments directly impact subsequent wash sale adjustments, minor calculation differences among reporting parties can result in substantially different, often altogether different, adjustments reported for identical patterns of activity.

The attached discusses some of the more pressing rule interpretation issues that require clarification so that wash sales may be applied consistently by all parties.

Sincerely,

Neal Ruskin
Chief Technology Officer
Silver Management Group, Inc.
nruskin@silvermanagement.com
609-275-9221



1. Shares Acquired Before Acquisition of Shares Sold

Consider the following simple example: An investor purchases 100 shares of stock on Jan 3, 2011, then another 100 shares of the same stock on Jan 18, 2011. On Jan 31, 2011, the investor sells the shares acquired on Jan 18 (via specific identification) at a loss. Do the shares acquired on Jan 3 constitute replacement shares thereby disallowing the loss?

Silver's position (as shared by Kaye Thomas of Fairmark Press on page 6 of his comments in response to Notice 2009-17) is that this sequence of activity does not constitute a wash sale since the Jan 3 shares were acquired before the Jan 18 acquisition date of the shares sold on Jan 31 and therefore cannot be considered replacement shares. More generally, shares acquired before the acquisition of shares sold should be disregarded when applying the wash sale rule.

Rev. Rul. 56-602 deals with a related point, clarifying that shares acquired at the same time as shares sold (in other words, as part of the same lot) are disregarded when applying the wash sale rule. Discussion of statutory intent includes:

"...Congressional discussions and reports refer consistently to the 'new acquisition' and to 'repurchasing' and 'buying back' stock or securities. These terms indicate an intent on the part of Congress to prevent a taxpayer's taking losses for tax purposes while giving up his position in a security for only a few days or not at all. However, they do not indicate an intent to disallow a loss sustained in a bona fide sale of securities made to reduce the taxpayer's holdings, even though the sale is made within 30 days after the securities were purchased."

Similar to the reasoning in Rev. Rul. 56-602, the Jan 31 sale in our original example can be viewed as a "bona fide sale... made to reduce the taxpayer's holdings". The sale has economic significance since the investor is clearly "giving up" the gain or loss exposure associated with the Jan 18 shares, while the exposure associated with the Jan 3 shares remains unchanged and ongoing. The continued existence of pre-existing exposure is a good indicator that acquisitions prior to the acquisition of shares sold do not represent replacement shares regardless of their presence within the 30 day period prior to the sale. The example sequence of activity clearly represents a reduction in taxpayer's holdings, not the replacement of one holding with another, and therefore should not constitute a wash sale. Conversely, had the Jan 3 shares been sold instead, the sale would not have economic significance and should be treated as a wash sale since the Jan 3 associated exposure is ended and another effectively equivalent exposure begun within a short period of time. (A contrary example in Rev. Rul. 76-316 may be cited but is clearly intended to clarify an unrelated point not to counter 56-602.)

Questions concerning this case arise almost without fail in each of our client engagements. Clarification of the above is requested with the strong recommendation that, consistent with the treatment of shares acquired at the same time as shares sold per Rev. Rul. 56-602, shares acquired before the acquisition of shares sold be disregarded when applying the wash sale rule.



2. Holding Period Adjustment

Related statutes and regulations are currently ambiguous with regard to determining adjusted holding period under the wash sale rules. S. Conlon, D. Collinson, and S. Rosenthal represent this issue well in their Jan 21, 2010 letter to Mr. Stephen Schaeffer. The issue is whether short or long term capital gains treatment upon disposal of wash sale adjusted shares is determined (a) by computing actual days held for the original shares plus any and all instances of replacement shares (referred to as the 'holding period' approach), or (b) using the acquisition date of the originally disallowed loss as the adjusted acquisition date for any and all instances of replacement shares (referred to as the 'holding date' approach).

Silver believes the holding period approach to be highly problematic and open to abuse, while the holding date approach is far simpler, more consistent with the intent of the wash sales rules, and cannot be similarly abused.

It is important to realize that under wash sale rules, losses may be deferred and re-deferred, in whole or in part, repeatedly and indefinitely until such time as all descendent components of the original loss are realized and remain subsequently un-deferred for 30 days. Such a pattern of wash sale adjustments is in fact the norm in actively traded accounts. Because of this fragmentation of original losses across multiple initial deferrals and subsequent re-deferrals, and dependant on the gaps and overlaps between relevant pairs of matched loss and replacement activity, it is quite possible under the holding period approach that some components of an original loss end up with short term treatment while others end up with long term treatment even when sold on the same day. Variable capital gains term treatment of a single original loss seems contrary to the intent of the wash sale rules, specifically that disallowed losses simply be carried forward until eventual realization, not transmuted in some way.

Further, as mentioned in the cover note, wash sales are very sensitive to initial conditions, meaning that minor changes to adjustments early in the lifecycle of a deferred loss can lead to significant differences in later adjustments. Any modification of historical account activity (e.g. commission rebate, trade re-bill, cost basis update for transferred-in shares, after-the-fact changes to corporate action terms) will propagate through related wash sale adjustments, producing at best widespread recalculation of gain or loss and subsequent deferrals and at worst completely different deferral structures, where different sets of acquisition and loss activity are matched. Holding period computations may therefore also yield different results should even minor historical modifications be applied to account activity, potentially requiring numerous 1099-B and transfer reporting restatements.

Finally, holding period computations provide opportunity for significant abuse. Gaps between recurring loss and replacement activity may be engineered to extend the period over which losses are treated as short term to as long as two years, and overlaps between one or more pairs of loss and replacement activity can in some circumstances be used to game long term treatment for short term gains. It is difficult to conceive that this is a desirable outcome.

In contrast, the holding date approach uses the acquisition date of an original un-adjusted loss to calculate capital gains term when any component of that original loss is eventually allowed (i.e. not re-deferred). Under this approach, the original acquisition date propagates unchanged through all descendant loss components, each of which receives identical term treatment upon final disposition. That is to say capital gains term is calculated for all components of a loss relative a single original acquisition date no matter the degree of fragmentation or the duration of deferral. All components closed on a single date receive identical treatment. Any and all components of an original loss closed within one year or less of the original acquisition date receive short term treatment, while any and all closed beyond one year receive long term treatment. Further, capital gains treatment remains constant regardless of activity patterns. No degree of change whether to individual gain or loss calculations or the entire deferral structure itself will impact term calculation upon ultimate disposition. Finally, since replacement share gaps and overlaps are irrelevant under the holding date approach, the potential for abuse discussed above does not exist.



While the language in 26USC1223(3) is open to interpretation, as is the statement on page 54 of the 2009 Pub 550, "Your holding period for substantially identical stock or securities you acquire in a wash sale includes the period you held the old stock or securities", the statement within the section specifically devoted to wash sales treatment on page 56 quite clearly states, "Your holding period for the new stock or securities begins on the same day as the holding period of the stock or securities sold." There is likely significant thought behind this second statement given its prominence, and it is our recommendation that this be the adopted holding period adjustment methodology for the reasons outlined.

Silver has found that significant confusion remains on this issue even among tax professionals. Clarification is requested with the strong recommendation that the current language on page 56 of Pub 550 be formalized via a ruling setting forth that the adjusted holding period be determined by maintaining original acquisition date regardless of replacement share gaps or overlaps.



3. Transfers And Other Non-Taxable Activity Not Subject To Wash Sales

Although current regulations seem fairly clear, Silver continues to encounter confusion about wash sales treatment of transfer activity. S. Conlon, D. Collinson, and S. Rosenthal also correctly represent this issue in their Jan 21, 2010 letter. The issue is whether transferred in shares can represent replacement shares for wash sales purposes and if so how to deal with various complications that arise from such treatment.

Silver's position is that all transfer activity, both into and out of an account, is non-taxable and therefore should be disregarded for wash sales computation. 26CFR1.1091-1(f) states, "The word acquired as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law". This is reiterated in Pub 550 wash sale instructions on page 56 which state that a wash sale occurs "when you sell or trade stock or securities at a loss and within 30 days before or after the sale you: 1. Buy substantially identical stock or securities, 2. Acquire substantially identical stock or securities in a fully taxable trade..." Both means of acquisition, purchase and fully taxable trade, are explicitly taxable. That the language would point this out certainly seems to imply that non-taxable activity be disregarded. Further, transfers between accounts owned by the same taxpayer are obviously non-taxable.

A potential area of abuse is often identified, specifically that treating transfers non-taxably facilitates a taxpayer spreading activity in an identical security across multiple owned accounts thereby attempting to hide wash sales. However, while the single account stipulation relieves brokers from identifying cross account wash sales, nothing in the legislation or proposed regulations relieves taxpayers of their own responsibility to compute wash sales adjustments across all owned, as well as related-party, accounts. While potential for this form of abuse may appear to lessen the utility of broker reporting for IRS cross checking purposes, such cross checking would be of limited value for taxpayers with multiple accounts anyway due to the divergent investor and broker reporting perspectives.

It is important to realize that non-taxable opening activity does not preclude taxable closing activity for the same shares. In other words, while the activity establishing transferred in shares in the destination account can not trigger a wash sale, transferred in shares may eventually be closed taxably at a loss which could then be disallowed by the rules should a taxable replacement acquisition be present.

Clarification is requested on the above issue, with the strong recommendation that transfers be considered non-taxable activity and that non-taxable activity be exempted from wash sales calculations.

4. Loss And Replacement Activity Spanning Quantity Adjusting Corporate Action Events

Per Section 6045(g)(2)(B)(ii), broker wash sale calculations are limited to matching loss and replacement activity only within individual accounts and for identical securities (as defined by an identical CUSIP). However, this does not absolve brokers from correctly determining basis for lots in successor entities such as arise from exchange, merger, spinoff and related events. Successor lot basis and structure necessarily include wash sale adjustments applied to predecessor lots (and, should historical activity for the predecessor entity change, must be recalculated to ensure updated wash sale adjustments are accurately reflected).

There is ambiguity when considering certain quantity adjusting corporate action events. In the case of both forward split and stock dividend events, the number of shares of existing lots is increased by a declared share ratio as of a declared effective date while basis remains unchanged. Post-effective date lots may be viewed as successor entities, although they retain the pre-effective date CUSIP. Since the CUSIP of pre and post-effective date activity is identical, brokers are required to match loss and replacement activity that spans the effective date, but it is not clear how the share ratio applied to adjust lot quantity should be taken into account.

For example, if prior to the effective date of a 10-for-1 forward split, a taxpayer sells 100 shares at a loss and acquires 100 replacement shares, the full loss is deferred and added to the basis of the 100 replacement shares. The same adjustment results when similar activity occurs entirely after the effective date. However, what should be the result if the taxpayer sells 100 shares at a loss prior to effective date and acquires 100 shares after the effective date? It could be argued that since 100 post-effective date shares are substantially identical to 10 pre-effective date shares, only the loss associated with 10 of the 100 shares sold should be deferred while that amount is added to the basis of all 100 replacement shares. The loss associated with the remaining 90 pre-effective date shares would remain un-deferred unless and until subsequent replacement activity for an additional 900 shares.

Applying the event share ratio when matching losses and acquisitions that span quantity change events would seem the obviously correct treatment. That is until considering reverse split events, which also adjust quantity while leaving basis unchanged, but which typically also result in successor lots in a new security (different CUSIP). The substantially identical security requirement remains in place for investors, meaning that from their perspective, treatment of reverse splits is analogous to treatment of forward splits and stock dividends. This is clearly not the case from the broker perspective however. The identical security simplification was adopted to reduce broker processing burden and remove uncertainty as to what exactly constitutes substantially identical securities. Were brokers required to incorporate a share ratio into wash sale calculations as described, there would need to be some means of storing and administering share ratios for all quantity adjusting events, a feature many brokers would have to source from scratch. Given the divergence in broker and investor wash sale rules already introduced by the identical security stipulation, it may make sense to permit brokers to match pre and post-effective date activity one-for-one for wash sales purposes.

Clarification of the above issue is requested with the recommendation that brokers be permitted to ignore ratio adjustments for loss and replacement activity spanning quantity adjusting corporate action events.



Silver Management Group, Inc.
114 Rabbit Hill Road
Princeton Junction, NJ 08550
Tel (609) 275-9221 Fax (609) 275-9226

<http://www.silvermanagement.com/>