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## A Primer on Wash Sale Reporting in a Volatile Market

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Market volatility can create opportunities for traders but it can also be a source of angst. And this is true in the world of tax as in the wider world. Amidst talk of recession and stock prices that have fuctuated wildly over the last year, investors in stocks or securities have much to be vexed about. As the year winds toward its final quarter, investors that may be thinking about taking losses for tax purposes (or reading ad-vice on “loss harvesting”) should also consider some of the tax imponderables that come with loss sales — most particularly the possibility of triggering tax wash sale rules. Opportunity and angst.

Under U.S. tax rules, investors that sell stock or securities at a loss and then repurchase substantially identical stock or securities close to the sale may be denied the loss for tax purposes.<sup>1</sup> Tax loss harvesting could inadvertently trigger wash sales because the

wash sale rules are not always intuitive. A “repurchase,” for example, can occur *before* the sale. Also, a wash sale could occur when there is a sale in one account and a purchase in a separate account that the taxpayer may be maintaining for completely different reasons.

More, for unwary investors, the complexity of the wash sales is also accentuated by the fact that 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 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, and how can investors avoid inadvertently subjecting themselves to the impact of these rules?

### WHAT ARE WASH SALES?

Wash sale rules were originally conceived to deter taxpayers from effectuating sales of stock or securities to take a loss for tax purposes without essentially having changed their economic position. The basic abuse scenario Congress was targeting when it enacted the wash sale rules is that of an investor that holds a stock or security at a loss, decides to sell the investment to take a loss for tax purposes but then repurchases the same, or substantially identical, stock or security close to the time of the sale. Without wash sale rules, the investor would be able to recognize a loss while reinvesting in the same investment, effectively recording a tax benefit when the investor’s economic position has remained unchanged. As discussed below, tax rules as early as 1921 prevented the investor from recognizing loss, but current codification of the wash sale rule under §1091 contains provisions that allow investors to adjust basis and holding period in the “replacement” shares so that the loss is not lost altogether. Effectively, the loss is added to the tax cost or basis of the shares that are repurchased within the wash sale window (30 days before and 30 days after the loss sale). In addition, the holding period of these replacement shares includes the holding period of the shares sold at a loss. When the replacement shares are eventually sold, the adjustments are intended to provide

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This article may be cited as Martin L. Mueller, Jr., and Nelson Suit, *A Primer on Wash Sale Reporting in a Volatile Market*, 63 Tax Mgmt. Memo. No. 20 (Sept. 26, 2022).

<sup>1</sup> §1091. All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

the taxpayer the benefit of the prior loss. The wash sale loss is thus in many cases merely deferred.

This deferral of loss and the consequent need to identify replacement shares and adjustments to basis and holding period create significant complexity, especially when there are multiple buys and sells or perhaps even short sales occurring within the wash sale window. The complexity is there for taxpayers attempting to calculate wash sales for their tax returns and for brokers that under tax information reporting rules need to maintain systems to manage reporting of wash sales.

As a simple example, an investor with \$100 basis in 100 shares of ABC, Inc. stock sells the shares at \$80, but then repurchases the same number of shares of ABC, Inc. at \$70. There are two distinctive results for the investor that depend on when the stock was repurchased. In the scenario where the repurchase of ABC, Inc. stock is after 30 days, Investor A would be entitled to a \$20 loss, while maintaining substantially the same position in ABC, Inc. stock as there is no wash sale triggered. However, in the case of Investor B, the wash sale rules disallow the loss. The loss instead is allowed as an adjustment to the basis of the newly purchased shares, in this case upward to \$90 (the loss of \$20 is added to the repurchase price). Thus, the loss on the initial sale by Investor B is deferred.

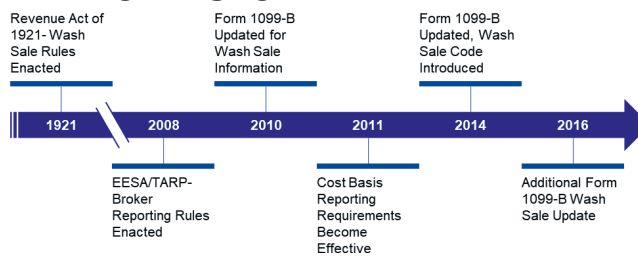
Investor A — No Wash Sale	
Basis	\$100
Mar. 31 Sale	\$80
June 15 Repurchase	\$70
Result	
Loss Recognized	\$20
Adjusted Basis (New Shares)	\$70

Investor B — Wash Sale	
Basis	\$100
Mar. 31 Sale	\$80
Apr. 15 Repurchase	\$70
Result	
Loss Recognized	\$20
Adjusted Basis (New Shares)	\$90

In addition to the basis adjustment, the holding period of the sold shares is generally tacked onto the holding period of the replacement shares.

What also makes this exercise difficult for a taxpayer 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, Treasury Secretary Andrew Mellon orchestrated the Revenue Act of 1921 (heretofore, “the Act”). Among the Act’s provisions were 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, we see the emergence here of the anti-wash sale concept.

Although not referenced in the statute as a “wash sale,” Act §214(a)(5) 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 a Senate Report,<sup>2</sup> written by the Committee on Finance prior to passage of the Act, the “Deductions Allowed 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 Senate 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 §1091, though the initial impact was

<sup>2</sup> S. Rep. 67-275, 67th Cong., 1st Sess. (Sept. 26, 1921), available at, <https://www.finance.senate.gov/imo/media/doc/RPT67-275.pdf>.

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” set forth in the Act.

Fast-forwarding several decades to a relatively recent recession, the financial crisis of 2007–2008 — a.k.a. 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)<sup>3</sup> 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 §6045 information reporting requirements by including new broker reporting rules for certain security transactions, beginning with certain transactions occurring on or 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, 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.<sup>4</sup> Moreover, the JCT report provides that “[s]ecurities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number.”<sup>5</sup> Thus, Congress created a more streamlined (read “different”) reporting framework for information that is that provided by brokers to investors, which inevitably provides room for reporting oversight for the unwary investor.

This is not to say that wash sales reporting is at all straightforward for brokers. Accounts with frequent trading activity may trigger a chain of wash sale deferrals, in which case broker systems would need to correctly identify portions, or all of the purchased shares (tax lots), that may be treated as potential replacement shares and adjust the basis of the existing lots or create new lots for basis accounting. Wash sale calculations can also be complicated when they occur

during corporate action events, such as a stock splits or corporate spin-offs. Short sales can also trigger wash sales and may, in some circumstances, interact with long positions. Due to the wash sale window being open for another 30 days after a sale, adjustments often need to be made retroactively, which creates operational issues for broker systems. Corrections may also require unravelling a string of complicated pairing of loss sales to replacement shares and tortuous recombinations to recalculate basis.

The preamble to the Proposed Regulations<sup>5</sup> noted that Treasury had received comments about requiring brokers to inform payees about discrepancies between the broker-reported basis and the basis that the payee must report on their income tax return. However, Treasury simply noted that brokers can communicate additional detail, if desired.

The IRS updated Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, for wash sale information reporting beginning with the 2011 calendar year. As noted in the 2011 Form 1099-B instructions,<sup>6</sup> 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,<sup>7</sup> 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 more or less on the current format, by eliminating the code and dedicating Box 1g of Form 1099-B to wash sale amounts. To date, the instructions have changed little for wash sales reporting since the original issuance.

## WASH SALE REPORTING REQUIREMENTS

As discussed, wash sale rules and cost-basis reporting rules contain nuanced differences that further complicate taxpayer requirements. Revisiting the example in the introduction, the investor purchased 100 shares in ABC, Inc. in January for \$100 and sells the shares for \$80 in March. The investor would initially be entitled to a short-term capital loss of \$20. 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

<sup>3</sup> Pub. L. No. 110-343.

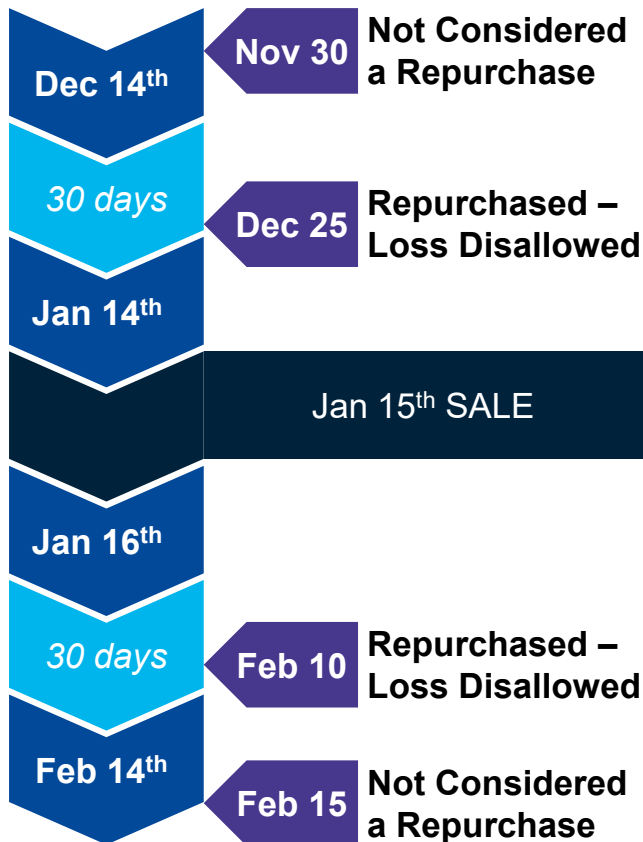
<sup>4</sup> See Joint Committee on Taxation (JCT) report, General Explanation of Tax Legislation Enacted in the 110th Congress, JCS-1-09, p. 365 (Mar. 2009), available at, <https://www.jct.gov/publications/2009/jcs-1-09/>.

<sup>5</sup> *Id.*

<sup>5</sup> REG-101896-09, RIN 1545-BI66, 74 Fed. Reg. 67,010 (Dec. 17, 2009).

<sup>6</sup> Available at, <https://www.irs.gov/pub/irs-prior/i1099b--2011.pdf>.

<sup>7</sup> Available at, <https://www.irs.gov/pub/irs-prior/f1099b--2014.pdf>.



§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 (wash sale window) which the investor and reporting broker will need to review. The reporting rules under §6045 track pretty easily under this simplified fact pattern, as the broker handling the transactions must provide the investor with information not-ing the disallowed wash sale loss on Form 1099-B, Box 1g.

However, the broker reporting/investor reporting symmetry breaks down as variables are added. Note that the §6045 rules specify that reporting by a broker is required only 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, 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 these transactions fall within the purview of the wash sale rules.

Further complicating matters, §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 §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. §1.1233-1(d)(1), cross-referencing §1091, mentions that stock of separate companies typically would not be considered substantially identical, except certain situations such as reorganizations. Similarly, bonds or preferred stock may not qualify as substantially identical to the common stock, except in certain situations involving convertibles. 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, providing guidance on a proposed revenue ruling, determined that the re-purchase 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, GCM 38285 stated “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.

As illustrated above, wash sale rules can be fairly vague and complicated. Further, investors should be aware that Forms 1099-B received from a broker may not always report a wash sale that the investor may nonetheless have to report. The IRS provides in Reg. §1.6045-1(d)(6)(iii)(B) that brokers are not required to report disallowed losses when the transactions occur in separate accounts as noted above, even if main-

tained by the same broker. The Form 1099-B instructions also exclude broker reporting if the security is transferred out to another account or into the current account before the wash sale transaction.

§1091 Wash Sale Loss Disallowance Rules	§6045 Cost-Basis Reporting Requirements
"Substantially identical stock or securities"	Identical securities
Review all accounts: <ul style="list-style-type: none"> <li>● Includes retirement accounts</li> <li>● Includes spousal accounts</li> </ul>	Review on an account-by-account basis only
Consider transfers in/out	Not required on transfers in/out before wash sale

## INVESTORS BEWARE OF INADVERTENT WASH SALE RULE VIOLATIONS

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 above, the substantially identical issue can be difficult for average traders pursuing fairly banal transactions. 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. Furthermore, the divergence in broker reporting rules outlined above means that there may be a gap between information appearing on a Form 1099-B and information that taxpayers may need to comply with in 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.