IRS Disavows Popular Year-End Tax Planning Move

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GR Review

In these turbulent economic times, the income tax savings that can be generated by selling loss securities can somewhat soften the blow of market declines. As a result, an often recommended year-end tax strategy is the "harvesting" of capital losses by selling stock or other securities that have declined in value.

However, the application of what is referred to in the tax law as the "wash sale" rules will operate to deny the current deduction of tax losses where the investor acquires "substantially identical" stock or securities within a specified time frame relative to the "loss transaction". These rules are premised on the proposition that as a result of the reacquisition of "loss" securities, the investor has not sufficiently terminated his or her economic position and has not therefore "sustained" the loss.

Specifically these rules apply if within a period beginning 30 days before the sale of the loss securities and ending 30 days after such date the investor acquires, or enters into a contract or option to acquire, substantially identical stock or securities.

Where these rules apply, although the loss is not currently deductible it is preserved for use at a later date. In essence, the tax basis of the new security is increased by the amount of the disallowed loss. This basis adjustment permits the disallowed loss to provide a tax benefit when the new stock or securities are sold.

Until recently, the wash sale rules seemed to be limited to cases where the same person realizes a loss and acquires, within the statutory time frame, stock or securities that are substantially identical to those that were sold. The rules do not contain any attribution provisions that would expand their application to transactions in which affiliates of the investor acquire the prohibited position. As a result, often in cases in which an investor can benefit from taxable losses but is otherwise inclined to bet on the financial improvement of a stock position, the investor may choose to employ a strategy pursuant to which he or she will dispose of stock in order to recognize a tax loss in the investor's personal account and thereafter reinvest in a similar security position through the investor's individual retirement account.

Recently in Revenue Ruling 2008-5 the IRS has sought to eliminate the use of this strategy. The Revenue Ruling provides that if an individual sells stock or securities at a loss and causes his or her IRA to purchase substantially identical stock within the specified time period, the loss on the sale of the stock is disallowed under the wash sale rules. This is because the IRS believes that the trust is the mere agent of the investor and that the individual should not be able to avoid the intent of the loss disallowance rules by utilizing a trust over which the individual has complete control to acquire that same position which was disposed of to create the tax loss.

Adding insult to injury, the IRS also ruled that the loss in these circumstances (unlike those resulting from a normal wash sale transaction) will not be preserved for use at a later date. The IRS denied the investor in the new Revenue Ruling any basis adjustment to his IRA account. As a result, the taxpayer in that case, by virtue of the application of the wash sale rules will have forever lost the ability to utilize the tax benefit inherent in the original position.

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