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General Comment

Comments on guidance needed with respect to the wash sale rule in connection with broker reporting of basis are attached.

Attachments

IRS-2009-0037-0007.1: Comment on FR Doc # E9-29855

Comments on Proposed Regulations

Basis Reporting by Securities Brokers and Basis Determination for Stock

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The most important omission from the proposed regulations on broker reporting of basis is guidance on how to apply the wash sale rule. The regulations are helpful in that they require the application of this rule (1) only when the purchase and sale occur within a single account, and (2) only when the purchase and sale involve identical securities (rather than substantially identical securities). Yet the regulations fail to address other issues as to which regulations and other authorities offer inadequate guidance.

One such issue might be called the replacement rule. The wash sale rule is intended to apply only in situations where the taxpayer has, within the wash sale period, replaced the securities sold at a loss. In some situations it is clear that a purchase made within the wash sale period could not have been used to replace the shares that were sold at a loss. The wash sale rule should not apply in these situations.

For example, a taxpayer might buy 200 shares of stock in a single purchase, and sell 100 of those shares at a loss within 30 days after the purchase. At the time of the sale, the taxpayer holds 100 shares that were purchased within the preceding 30 days, yet the wash sale rule should not apply because those shares could not possibly have been purchased to replace the shares sold at a loss. The Internal Revenue Service has issued guidance confirming this conclusion (Rev. Rul. 56-602).

However, this ruling does not address other situations where the same conclusion is justified. For example, a taxpayer may buy 100 shares of a stock, and another 100 shares of the same stock ten days later. Five days afterward, the taxpayer may sell the second lot at a loss. By its literal terms the wash sale rule would apply to this sale, but this is an inappropriate application of the rule because the remaining shares that were purchased within the wash sale period could not have been purchased to replace the shares that were sold at a loss, because the loss shares were purchased afterward.

To address this issue, Rev. Rul. 56-602 should be replaced with broader guidance to the effect that securities purchased at the same time as or earlier than the securities sold at a loss will be ignored in applying the wash sale rule.

Guidance is also needed with respect to the application of the wash sale rule to taxpayers who engage in short sales of securities. These transactions raise two problems under the wash sale rule: (1) avoiding the application of the wash sale rule when the taxpayer switches between

short and long positions, and (2) choosing the correct date from which to measure the wash sale period.

The first problem can be illustrated by the following example. A taxpayer holding no shares of a stock makes a short sale of 100 shares, anticipating that the stock will decline in value. Contrary to that expectation, the stock value goes up, and ten days after making the short sale the taxpayer closes the short position at a loss, which entails buying shares in the market and delivering them to replace the shares that were borrowed to make the short sale. Five days later, the taxpayer buys another 100 shares of this stock.

The taxpayer has sold 100 shares at a loss (the shares purchased to close the short sale) and bought 100 shares within the wash sale period. Yet the wash sale rule should not apply because the newly acquired shares do not restore the taxpayer to the same investment position as the one that produced the loss; in fact, the taxpayer is now in exactly the opposite position (100 shares long instead of 100 shares short). Guidance on the wash sale rule should clarify that the rule does not apply when the taxpayer switches between short and long positions.

A further problem is determining the date that should be used to measure the wash sale period for a loss incurred on a short sale. The proper date depends on the nature of the transactions. In one example, a taxpayer who does not own shares of a stock may establish a short position that incurs a loss over a period of time as the stock value rises. Wishing to recognize the loss without more than a brief change in the investment position, the investor might close this short position and open another shortly before or after the date on which the first one was closed. In this situation, the wash sale period should be measured from the date the short position was closed.

On the other hand, a taxpayer may enter into a short position while owning shares that have declined in value (in other words, sell short against the box). If the taxpayer uses the previously owned shares to close the short position, the date on which the short position was opened, rather than the date it was closed, must be used to measure the wash sale holding period. Otherwise, a taxpayer holding shares that have declined in value could avoid the wash sale rule through a combination of transactions in which he first simultaneously buys replacement shares and makes a short sale (leaving his net position unchanged) and 32 days later uses the previously owned depreciated shares to close the short position.

Taxpayers have grappled with these and other issues relating to the wash sale rule for many years. Now, for the first time, taxpayers will receive information from their brokers indicating whether the wash sale rule has applied to their transactions and the effect of applying it. To assure that this information is as accurate as possible, the regulations should include or be accompanied by guidance addressing the issues described above.