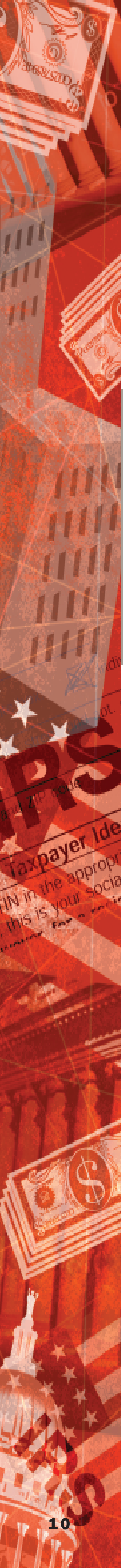
By Leonard G. Weld and Michael L. Holland



Losses Can Be Tricky

The tax treatment of losses on the sale of securities is more complex than the treatment of gains. Taxpayers should be mindful of the restrictions and limitations—such as the related party rules and wash sale rules—that may result in a deduction being disallowed.

Under normal circumstances, the tax treatment is straightforward when a taxpayer sells a security. The realized gain or loss is equal to sales price less selling expenses minus the cost of the security plus any fees/commissions paid when purchased. But there are circumstances that can disallow losses. One complication is the related party rules of IRC §267, which can result in losing the loss deduction being disallowed when selling property to a family member or a family partnership. Another complication is the wash sale rules of IRC §1091, which disallow losses when the taxpayer buys substantially identical stock or securities within a 60-day window around the sale date. Let's look at situations that fall under the purview of IRC §267 and §1091 that may disallow a taxpayer's losses.

General Rule and Limitations

Subsection (a) of IRC §165 allows a taxpayer to deduct losses incurred on the sales of investments. It states, "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Deductions of individuals are limited to losses in three categories: from business, from profit-seeking activities (investments, rental property, etc.), and from casualty or theft losses.

In addition, IRC §165 references IRC §1211, which imposes an overall limitation on the deduction of capital losses. Securities owned by a taxpayer are capital assets unless the taxpayer is in the business of selling securities. The overall limitation only allows losses up to $3,000 to be deducted in any one tax year. Fortunately, gains and losses can be netted, and the limitation only applies to the excess capital loss remaining.

Consider the following example: In 2010, Harry sold 100 shares of XYZ stock at a loss of $10,000. He also sold some vacant land he had bought four years ago, realizing a gain of $6,000. Harry can combine the $10,000 loss and the $6,000 gain, resulting in a net loss of $4,000. He can use $3,000 of the loss in 2010 and carry the remaining $1,000 forward to 2011.

Related Party Rules

Harry's loss would be disallowed if he sold the XYZ stock to his brother. IRC §267 disallows any loss from the sale or exchange of property, directly or indirectly, between members of a family, a corporation or partnership when the taxpayer has direct or indirect ownership of more than 50%, or several relationships between individuals, grantors, and fiduciaries of trusts.

The phrase "direct or indirect ownership" applies the tax concept of constructive ownership. The ownership of partnership interests or stock by a taxpayer's family member is attributed to the taxpayer selling the stock. If Harry had sold the XYZ stock for a $10,000 loss to a partnership in which he has a 30% interest and his wife has a 30% interest, then Harry indirectly owns a 60% interest in the partnership, and the loss will be disallowed.

If Harry sold the land to his brother for a gain and the XYZ stock to an unrelated person or broker for a loss, the $6,000 gain would still be included in his income. The result would be the same as in the example because only the loss on a sale to a related party is disallowed.

Now consider a different example: In 2010, Harry inherited a farm from Uncle Al. Although he paid nothing for the farm, he uses the farm's fair market value of $400,000 as his "cost." This is called the stepped-up basis of inherited property. Harry doesn't want the farm but wants to keep it in the family. He sells the farm to his sister Susan, but for only $300,000 because that's the most she can qualify for on a mortgage. Harry has a loss of $100,000, but none of it is deductible since he sold the property to his sister.

In this example, Harry has created a transfer tax issue by transferring the farm to his sister for less than fair market value. The $100,000 difference is subject to transfer tax declaration.

Wash Sale Rules

The wash sale rules found in IRC §1091 are intended to disallow a loss on the sale of securities within a short period of time that leaves the taxpayer in the same economic position as before the sale.

For example, Buddy buys 10 shares of XYZ stock for $100 per share on July 1, 2010. On December 31, 2010, he sells all these shares for $30 per share. On January 2, 2011, Buddy purchases 10 shares of XYZ for $30 per share. Without the wash sale rules, Buddy would deduct a capital loss of $70 per share in 2010 even though he is in the same economic position. With the rules, however, the loss is disallowed.

The wash sale rules date back to 1921. Except for updates about new financial products, they remain substantially unchanged. The rules don't apply to all taxpayers. If the taxpayer is a dealer in stock or securities who makes a trade in the normal course of business, IRC §1091 doesn't apply, and the loss is allowed.

The wash sale rules center on the date of the sale of securities for a loss. Within 30 days before or after the date of a security sale, a taxpayer can't acquire substantially the same security. The Internal Revenue Code or Treasury Regulations don't provide a definition of "substantially the same security," but it's flexible and applied on a case-by-case basis. Treasury Regulations state that "where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired… or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed…." Therefore, purchase of a contract or option counts the same as purchasing the security.

Here are some examples of identical securities taken from court cases and IRS rulings:

- Securities with the same par value, interest yield, unit price, and the same security behind the obligation;
- Bonds that are identical except that one is issued with interest coupons and the other in registered form;
- Two series of debentures of the same corporation with different issue dates and annual redemption amounts;
- U.S. Treasury coupon (bearer) bonds and registered bonds of equal face amount and interest rates, with only a six-month difference in call dates, and maturity dates that are only six years and nine years, respectively, from the date of purchase and sale; and
- Common stock and voting trust certificates for the same common stock.

Sometimes the repurchase may be inadvertent, but the result is the same. The loss on a sale in December can be disallowed by a Dividend Repurchase Investment Plan (DRIP) that purchases shares of the same stock in January. Mutual fund reinvestment plans can have the same effect on losses. Selling personally owned securities and then having a traditional or Roth IRA controlled by the taxpayer purchase substantially identical stock or securities will disallow the loss.

In another example, an employee who received shares of an employer's stock as bonus was considered to have made acquisitions of stock within meaning of IRC §1091. The bonus shares were considered "purchased" by the employee's labor. A loss from selling earlier bonus shares within 30 days of receiving subsequent bonus shares was disallowed.

One significant exception to the wash sale rules occurs when securities aren't acquired in a purchase or exchange. The wash sale rules don't apply if a taxpayer sells

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securities and then receives the same securities as a gift or inheritance. In that scenario, there's no action on the taxpayer's part that results in acquisition of the shares.

In summary, all gains on the sale of securities are included in the taxpayer's gross income. It doesn't matter if the gain came from the sale of property to a related party or if the taxpayer repurchases the security within days. The rules for losses, however, are much different. A taxpayer can lose the benefit of a loss deduction through the application of the related party or wash sale rules. The gains are easy, but the losses can be tricky. **SF**

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