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Scrubbing the Wash Sale Rules

David M. Schizer

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Scrubbing the Wash Sale Rules

By David M. Schizer¹

Draft of January 21, 2004

¹ Wilbur H. Friedman Professor of Tax Law, Columbia Law School. Copyright 2003. David Schizer. All Rights Reserved. I appreciate the helpful comments of Peter Canellos, Victor Fleischer, Erika Nijenhuis, Alex Raskolnikov, Michael Schler, Dana Trier, Alvin Warren, Robert Wooten, Larry Zelenak, and participants at the University of Chicago Federal Tax Forum. I appreciate the support of the Milton Handler Summer Research Program. Portions of this discussion are drawn from David M. Schizer, *The Taxation of Financial Instruments: Special Rules* (BNA Tax Management Portfolio) (forthcoming 2004). Please relay comments to the author at dschiz@law.columbia.edu or at (212) 854-2599.

Loss limitations are an ugly but inevitable feature of any realization-based income tax.² In essence, because the system mismeasures gains, it also has to mismeasure losses. Otherwise, the “timing option” inherent in the realization rule would allow taxpayers to defer gains (thereby reducing the tax’s present value) while accelerating losses (thereby preserving the deduction’s present value). This “strategic trading” would erode the tax on risky positions, leading to inefficiencies as taxpayers developed a taste for risky positions, became “locked in” to appreciated positions, and sold loss positions they otherwise would keep. Distributional issues also would arise as the effective tax rate on capital income fell.³ In theory, we could address these problems by abandoning the realization rule but, for reasons of politics and administrability, this Article assumes that the tax on gains cannot be accelerated. Instead, this Article seeks to curtail the timing option by deferring losses.

The wash sale regime of Section 1091 is one of our system’s most important brakes on the timing option.⁴ In broad outline, this regime defers a taxpayer’s deduction when she sells a position at a loss (the “loss position”) and, within a specified period of time (the “window period”), acquires an economically similar position (the “replacement position”). Yet the wash sale regime is quite old, and the recent Bear market has further

² See generally Alvin C. Warren, Jr., *The Deductibility by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. Chi. L. Rev. 291, 310-15 (1972). Under the realization rule, no tax is due on appreciated property until it is sold.

³ A number of excellent articles have detailed efficiency and distributional problems associated with the timing option. See, e.g., George M. Constantinides, *Capital Market Equilibrium with Personal Tax*, 51 *Econometrica* 611 (1983); Calvin H. Johnson, *Deferring Tax Losses with an Expanded 1211*, 48 *Tax L. Rev.* 719 (1993); Robert H. Scarborough, *Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax*, 48 *Tax L. Rev.* 677 (1993); Daniel N. Shavero, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *Tax L. Rev.* 1 (1992); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 *Yale L. J.* 1817 (1990).

⁴ Other constraints include the nonrefundability of our tax system, capital loss limitations, at risk rules, passive activity loss rules, and the straddle rules. For a brief discussion of the capital loss limitations, see *infra* Part II.D. The other loss limitations are beyond this Article’s scope.

exposed its frailty. Indeed, it is only a slight exaggeration to say that compliance with the regime is voluntary for very wealthy taxpayers – or, at least, for those who are willing to take aggressive positions.

In response, this Article flags seven glitches in the regime that, at least arguably, permit “perfect end runs.” As used here, this phrase refers to strategies in which taxpayers can deduct losses while effecting *virtually no change* in their economic position. For example, some advisors believe the regime does not apply to “periodic” equity swaps⁵ or to certain strategies involving out-of-the-money call options.⁶ Most of these perfect end runs are already controversial under current law. Indeed, many tax lawyers conclude that they do not “work.” Yet at least *some* advisors continue to recommend these strategies, so clear guidance is needed. The essential point is that, if we are going to have a wash sale regime, these end runs should not be allowed. A deduction is inappropriate if taxpayers have made essentially no change in their economic position.

In addition to identifying perfect end runs, this Article also takes a more controversial position: Losses should still be deferred – even when taxpayers make meaningful changes in their economic position – as long as they keep material elements of their old return. This Article offers two justifications for this broad loss deferral. First, under the “parity” goal, it should be difficult to accelerate losses because it is so easy, under current law, to defer gains. Put another way, since modest economic changes do not trigger gains, they should not trigger losses either. Second, under the “effectiveness”

⁵ Swaps are “private agreements . . . to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts.” John C. Hull, *Options, Futures, and Other Derivative Securities* 111 (2d ed. 1993). For an example, see *infra* note 41.

⁶ A call option entitles (but does not obligate) the taxpayer to buy the underlying property for a specified “exercise” price during a specified period. An option is “out of the money” when the exercise price exceeds the underlying property’s current value.

goal, the regime should be sufficiently tough that taxpayers actually *give up* on tax-motivated loss harvesting, instead of merely pursuing this planning in a more sophisticated way.

The policy goal here, then, is to ensure that, on average, taxpayers expect losses to be deferred as long as gains. One way to implement this objective is to coordinate the wash sale regime with the constructive sale regime of Section 1259.⁷ Since taxpayers can defer gain under Section 1259 when they keep only a portion of their investment's economic return (e.g., appreciation from \$100 to \$120 on an asset that is worth \$100), they should have to defer loss under Section 1091 whenever they keep an equivalently modest fraction of the return (e.g., a call spread offering the same \$100 to \$120 of appreciation). In general, any replacement position that offers as much economic exposure as a \$100 – \$120 call spread should trigger a wash sale.⁸ The goal here is not to propose this “call spread” approach as a statutory test, since the standard would be hard to administer. Rather, the “call spread” approach is offered as a theory for policymakers to determine the “right” answer as a matter of policy.

Fortunately, current law already comes to the right answer in some cases. Most importantly, it finds a wash sale when stock is replaced with a call option. Commentators generally attack this result as overbroad, since options are economically different from stock.⁹ In response, this Article defends this widely criticized rule, showing that it is

⁷ Section 1259 treats certain appreciated positions as sold when they are hedged with short sales against the box, total return equity swaps, forward contracts, and other transactions having substantially the same effect. For a discussion, see David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Colum. L. Rev. 1312 (2001).

⁸ In a call spread, a taxpayer buys a call (e.g. with a \$100 exercise price) and sells a call (e.g. with a \$120 exercise price). The taxpayer thus earns a return as the underlying appreciates above the lower bound (e.g. \$100) but stops earning an additional return once the underlying property's value exceeds the upper bound (e.g. \$120).

⁹ See, e.g., Erika Nijenhuis, Wash Sales Then and Now, Taxes (March 2004).

appropriate in light of our system's generous treatment of gains. Of course, other aspects of current law do not conform to the "call spread" theory. In response, this Article recommends specific changes (or at least clarifications) of current law. For instance, a wash sale should be triggered when stock replaces a call option, when a put option replaces a short sale,¹⁰ when equity-linked life insurance replaces an investment in the underlying equity, and when one sector-specific mutual fund replaces another. After making the case for a tougher wash sale regime, the Article cautions that this case is less strong if the regime can never be tough enough to stop loss harvesting (e.g., because taxpayers can always ensure the deduction by accepting a sufficiently drastic change in economics). If this outcome is likely, other constraints on the timing option may be preferable, including accelerated timing for gains or a broader capital loss regime.

Part I offers an overview of Section 1091. Part II outlines efficiency and equity justifications for this regime and describes its interplay with the capital loss limitation. Part III flags seven perfect end runs, and also an instance of overbreadth involving short sales. Part IV offers the case for a broader regime.

I. Overview of the Wash Sale Regime

In general, the wash sale rules of Section 1091 limit a taxpayer's ability to deduct losses from selling depreciated stock or securities if, within a specified period of time, the taxpayer replaces this property by acquiring substantially identical stock or securities or by entering into a contract or option to acquire substantially identical stock or securities.¹¹

¹⁰ A put option is an option to sell the underlying property for a specified exercise price during a specified period.

¹¹ Code Sec. 1091(a) ("In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities 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 (by

For instance, assume that a taxpayer sells a share of ABC common stock with a basis of \$100 for \$80 on November 1. He cannot deduct this loss if he purchases a share of ABC common stock on November 2 – or, indeed, at any time beginning thirty days before the loss position is sold and ending thirty days thereafter.

If Section 1091 applies, it defers the taxpayer’s deduction, effectively adding it to the basis of the replacement position. Under Section 1091(d), the basis of the loss position generally carries over to the replacement position,¹² as does the holding period.¹³ Thus, if a taxpayer sells property with a basis of \$100 for \$80, and immediately purchases substantially identical property for \$80, the taxpayer’s basis in this replacement position is \$100. If he later sells it in a transaction that is not a wash sale for \$80, he recognizes a \$20 loss.¹⁴

The regime also includes special rules that match loss positions with replacement positions. In general, a chronological convention determines which loss position is the

purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165”).

¹² Code Sec. 1091(d) (“If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.”).

¹³ Code Sec. 1223(4) (“In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under Section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.”); see also Reg. § 1.1223-1(d).

¹⁴ What if the purchase price paid for the replacement position diverges from the sale price received for the loss position? To account for these differences, Section 1091(d) also provides an adjustment to the replacement position’s basis. See Code Sec. 1091(d).

subject of a wash sale if more than one is sold during the window period,¹⁵ or if the loss position is larger (or smaller) than the replacement position.¹⁶

II. Policy Goals of the Wash Sale Regime

At first blush, the wash sale rules are puzzling. When investments lose value, taxpayers suffer real economic losses. Once the investments are sold, there is no question about the *amount* of this loss. So why shouldn't it be deductible? After all, our system is supposed to measure ability to pay, and an investor with losses has less to contribute than an investor with gains. So why does the system turn a blind eye to these losses?

The answer is that, in a realization-based system, the tax law already turns a blind eye to gains. The need to match the treatment of losses with the treatment of gains is familiar. After all, if we reduced the capital gains rate to zero, would we still allow taxpayers to deduct capital losses? Likewise, should taxpayers be allowed a deduction when investments in a Roth IRA lose value?¹⁷ The same question is posed when the tax on gains is reduced through deferral, instead of a rate cut. Under current law, deferring gains is easy, even if taxpayers eliminate most of their exposure to the appreciated asset. Given this generous treatment of gains, losses also need to be deferred when taxpayers keep enough exposure. Unless the deductibility of losses is limited, the government loses substantial revenue, investment allocations are distorted, and distributional issues arise as

¹⁵ If the taxpayer makes more than one sale of depreciated property within a taxable year, the wash sale regime applies chronologically. According to Treas. Reg. § 1.1091-1(b), the regime “shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition).”

¹⁶ Thus, if more property is sold than purchased – such that the loss position is larger than the replacement position – losses are disallowed with respect to the loss position that was acquired *first*. Reg. § 1.1091-1(c). Correspondingly, if more property is acquired than sold – such that the replacement position is larger than the loss position – the new property that was acquired earliest (and thus is the least new) is credited with extra basis and holding period under Section 1091. Reg. § 1.1091-1(d).

¹⁷ In a Roth IRA, taxpayers invest after-tax dollars and earn a tax-free yield.

the effective tax rate on investment income declines (and may even become negative). While Section 1091 obviously is not the system's only constraint on the timing option, it provides significant reinforcement to the capital loss limitation, a more general backstop. These familiar points are briefly considered in turn.

A. Revenue and the Timing Option

In our realization-based system, taxpayers can erode the present value of tax through deferral, and can eliminate the tax entirely through a basis step-up at death.¹⁸ In contrast, if the investment declines in value, the tax-reducing strategy is to sell it immediately, triggering a current deduction whose present value is not reduced by deferral. It is well understood that this strategic trading, if unconstrained, causes dramatic declines in government revenue. For example, while deferring investment gains, taxpayers will use investment losses to shelter income from other sources, including their salaries. In response, the wash sale regime protects government revenue by making it more difficult to deduct losses.

B. Efficiency and the Timing Option

1. Efficiency Costs of the Timing Option

An unconstrained timing option also breeds inefficiency. As Daniel Shaviro has emphasized, it distorts investment decisions both “ex ante” and “ex post.”¹⁹ The ex ante distortion arises when taxpayers choose which investments to buy. The source of the distortion is that, if the timing option is unconstrained, the government's share of gains on any investment is smaller than its share of losses. This uneven allocation raises the

¹⁸ Code Sec. 1014. Along with the estate tax, Section 1014 is scheduled for repeal in 2010, but is scheduled to be reinstated the following year.

¹⁹ See generally Shaviro, *supra* note 3. As the term “efficiency” is used here, taxes are “efficient” if taxpayers pay them without changing their behavior.

after-tax present value of any bet.²⁰ Increasing the riskiness of the bet intensifies this effect, causing the aftertax fair market value to rise even further. In other words, the timing option creates a tax-based preference for risk.²¹

In addition to influencing which investments taxpayers *buy*, the timing option also affects which ones they *sell*. There are two versions of this ex post distortion. First, taxpayers tend to keep investments that have appreciated, even if they would prefer to hold something else. This phenomenon is commonly called “lock-in.” Second, taxpayers tend to sell investments that have declined in value, even if they otherwise would keep them.²²

These distortions cause social waste in three ways. First, taxpayers are less happy with their portfolios. They do not necessarily have the investments they want most. Second, market prices are distorted – for instance, risky and recently appreciated investments are likely to be overpriced – causing resources to be misallocated.²³ Third, taxpayers engage in wasteful planning strategies to circumvent the rules. For example, instead of selling appreciated property, they use derivatives to hedge. This planning can mitigate the first two problems – making taxpayers happier with their portfolios and improving the accuracy of market prices (i.e., since taxpayers who want to sell are, in effect, doing so). But this self help causes its own social waste in the form of advisory

²⁰ For example, consider a coin toss in which a taxpayer pays \$100 if he wins and receives \$100 if he loses. This bet has zero fair market value (assuming the coin is fair). A 50% tax will not affect this fair market value (assuming there is no timing option and losses are fully deductible), and merely reduces the bet’s volatility (so the taxpayer wins or losses \$50, instead of \$100). But what if a timing option reduces the government’s share of gains to 25% (i.e., because of tax deferral), while keeping the government’s share of losses at 50%? The bet yields \$75 aftertax if the taxpayer wins, costs only \$50 aftertax if he loses, and thus has a fair market value of \$12.50.

²¹ See generally Shaviro, *supra* note 3. The normative premise here is that, to the extent possible, the tax law should be neutral as to risk. While some types of risk-taking have positive externalities, including research and development, narrowly targeted subsidies should be used for this purpose.

²² See generally Shaviro, *supra* note 3.

²³ For example, high-risk projects may receive funding even if they have negative net present value.

fees, time and energy devoted to planning, and deal structures that otherwise do not make sense.

3. Efficiency Benefits of Wash Sale Rules

By constraining the timing option, the wash sale rules can mitigate some of these distortions. The goal is to discourage tax-motivated sales. To do so, the wash sale regime burdens loss harvesting with a nontax cost (or so-called “friction”): taxpayers have to give up economic exposure to the depreciated asset (or double their exposure) for a specified period. The hope is that this friction is so unappealing that taxpayers choose, instead, to forgo the tax deduction.²⁴

If taxpayers choose this tax-expensive route – and the word “if” is quite important, as emphasized below—the wash sale rules offer efficiency benefits. Taxpayers are happier with their portfolios. Market prices are more accurate, since there is no barrage of tax-motivated sales to depress prices. In addition, by discouraging loss harvesting, ex post, the wash sale rules mitigate the tax-based preference for risk, ex ante. If taxpayers expect losses to be deferred to the same extent as gains, risky assets no longer have special appeal.

4. Efficiency Costs of the Wash Sale Regime

Yet these efficiency benefits are not complete or, for that matter, free. Obviously, the wash sale rules do not prevent planning strategies to defer gains. The regime adds complexity to the Internal Revenue Code, raising administrative costs. It also is overbroad in some cases, blocking behavior that is not tax-motivated. For instance, a taxpayer who sells depreciated property because she no longer wants it (i.e., and not merely to harvest losses) may then be deterred from reacquiring it when circumstances

²⁴ See generally Schizer, *supra* note 7.

change. To an extent, taxpayers caught in this sort of bind may lose confidence in the tax system, a potentially significant cost in a system that depends on voluntary compliance.

These costs arise even if the wash sale regime “works” – that is, if it *actually stops* loss harvesting. What if this is not so? What if the regime is not tough enough to actually stop the practice, but merely makes it more costly? In this case, from an efficiency standpoint, the regime is counterproductive. Taxpayers still change their behavior in response to taxes (i.e., by selling depreciated assets that they otherwise would keep), but they have to go to greater lengths to do it. Social waste increases as taxpayers make greater sacrifices to claim the deduction, but there is no corresponding increase in revenue. Put another way, the wash sale rules have a more positive influence on marginal taxpayers (who are deterred from harvesting losses) than on inframarginal taxpayers (who are not deterred).²⁵

To sum up, the wash sale regime can enhance the efficiency of a realization-based system, but only if crafted with care. Complexity and uncertainty can breed excessive administrative costs. Overbreadth can deter “good” transactions that are not tax motivated. Finally, the regime needs to be tough enough to reach the tipping point where enough taxpayers are actually deterred from harvesting losses. Policymakers should balance these various goals in a way that minimizes overall waste. In addition, other measures are needed to address lock-in and the deferral of gains, a topic that is beyond this Article’s scope.

²⁵ See generally Louis Kaplow, *Optimal Taxation with Costly Enforcement and Evasion*, 43 *J. Pub. Econ.* 221, 233 (1990) (emphasizing tradeoff between marginal and inframarginal taxpayers); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 *Tax Notes* 221, 223 (2000) (same); Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 *Int’l Monetary Fund Staff Papers* 172, 179-82 (1996) (describing potential social waste from tax reforms).

C. Equity

1. Vertical Equity

In addition to promoting efficiency goals, the wash sale rules also can make the tax system more equitable. Unless the timing option is constrained, the effective tax rate on investment income is quite low, especially for risky assets.²⁶ Indeed, sophisticated taxpayers are likely to generate deductible investment losses to shelter other income. This low (or even negative) tax burden on investments raises vertical equity concerns since investment income is concentrated among wealthier taxpayers. The wash sale rules can promote vertical equity, then, by constraining the timing option and thus raising the tax burden on investment income.

Two caveats are important here, though. First, it is difficult to make judgments about vertical equity without considering other aspects of the tax system. In theory, a low tax burden on the investment income of wealthy taxpayers (due to the timing option) can be offset, for instance, by a correspondingly high tax burden on their wages. Thus, a tougher wash sale regime is only one way to promote vertical equity, and it may not be the best way.

Second, assuming that vertical equity goals should be pursued through the wash sale regime, vertical equity is clearly enhanced if the wash sale rules are effective for *all* taxpayers. Yet if the wealthiest taxpayers can avoid this regime with sophisticated planning, while moderately wealthy taxpayers cannot, the wash sale rules have an ambiguous effect on vertical equity. Since moderately wealthy taxpayers still have relatively high incomes, the regime is helpful in raising the tax burden on their

²⁶ Ironically, a high nominal tax rate can intensify this effect, increasing the government's share of losses without correspondingly increasing its share of gains.

investment income. Yet this vertical equity advantage obviously is incomplete – and, indeed, is undermined – if even wealthier taxpayers avoid the regime with ease. The implication, then, is policymakers should target “high-end” avoidance strategies, as well as “mainstream” ones.

2. Horizontal Equity

There also is a plausible case for the wash sale rules on horizontal equity grounds – that is, the idea that like taxpayers should be taxed alike. For instance, consider two (otherwise identical) taxpayers, Andrew and Bill, who buy XYZ stock for \$100, and its value declines to \$60. Assume that one continues to hold the stock while the other sells and immediately repurchases it. Given their similarity, Andrew and Bill presumably should be treated the same way. Under a realization system, this means neither gets to deduct the loss.

Yet this horizontal equity defense is less persuasive once we add a third (otherwise identical) taxpayer, Charlie, who sells his XYZ stock and does not repurchase it. All three have the same economic loss, but only Charlie can claim a deduction, since the wash sale rules do not reach him. Why is he more deserving than the other two? The traditional answer is that Charlie severs economic ties with the stock, thereby making a “real” sale, and this difference justifies a deduction in a realization-based system. Yet this reasoning leans very heavily on the realization rule – not just on the fact that it *is* the law, but on the idea that it *should be* the law on a deeper normative level. This reasoning imputes (perhaps surprising) moral authority to a rule that exists for administrative

convenience.²⁷ Are people who *sell* depreciated property really more deserving of a low tax bill than those who keep it? If we look to more fundamental policy values, such as the desire to base burdens on ability to pay, it obviously becomes much harder to distinguish Charlie from Andrew and Bill. They *all* have suffered an economic loss.

To sum up, then, there are equity-based justifications for the wash sale rules, sounding in both vertical and horizontal equity, but each is subject to objections. Why should we pursue distributive justice in this manner, instead of by adjusting the rate schedule for wages? Why should we favor a taxpayer who does not repurchase depreciated property over one who does? In light of these concerns, efficiency justifications are this Article's principal focus.

D. Imperfect Overlap With the Capital Loss Limitations

Before turning to the details of Section 1091, it is worth emphasizing that other loss deferral regimes also constrain the timing option. The most general backstop is the capital loss limitation.²⁸ Corporate taxpayers cannot deduct capital losses unless they have capital gains. Individuals are similarly constrained, except that they can deduct \$3000 of capital losses each year from ordinary income.

This regime is a fairly effective constraint on the timing option, since taxpayers cannot deduct losses unless they are also recognizing gains. When the capital loss limitations do the necessary work, Section 1091 is redundant. Consider investors in the Internet bubble who now have large reservoirs of capital losses. These investors are effectively subject to a zero tax rate on any new capital-gain-yielding investments. The

²⁷ Admittedly, some commentators do defend the realization rule on normative grounds, but they are in the minority. See e.g., Edward Zelinsky, For Realization: The Virtue of Attainable Virtues, 19 *Cardozo L. Rev.* 861 (1997).

²⁸ See Code Sec. 1211. For other constraints that are beyond this Article's scope, see *supra* note 4.

wash sale rules have no effect on them, since they cannot deduct losses anyway. This reality reduces the need for a tough wash sale regime but, at the same time, reduces the harm it could cause (for instance, from overbreadth or complexity).²⁹

Even so, the overlap between Section 1211 and Section 1091 is incomplete, so that a tough wash sale regime can still make two important contributions. First, the capital loss limitation keeps capital losses from sheltering ordinary income, but obviously does not prevent the sheltering of capital gain. As a result, the regime keeps the effective tax rate on capital gain from falling *below* zero, but does not ensure that it will be *above* zero. Yet policymakers may prefer a positive effective tax rate on vertical equity grounds or, for that matter, on efficiency grounds if collecting this tax is less distortive than other taxes. Indeed, a zero rate is of particular concern because capital gain is defined porously, including wages and interest-based returns in some cases.³⁰ Needless to say, there are many ways to raise the tax burden on capital gain, but a tough wash sale regime can play a role by raising the cost of loss harvesting.

Second, if the taxpayer already has gains that she must recognize in a given year, the capital loss limitations have no effect on *any other* investments she has. Consider a wealthy investor who puts a fraction of her portfolio into a hedge fund, which generates an impressive pretax return but a lot of short term capital gain each year. On her other

²⁹ In any event, empirical evidence from earlier bull markets suggests that large pools of capital losses are fairly uncommon among individual taxpayers. They tend to use these losses eventually, and are seldom left with losses they never deduct. See Alan J. Auerbach et al, *Capital Gains Taxation and Tax Avoidance: New Evidence From Panel Data, in Does Atlas Shrug?* 355 (Joel Slemrod ed. 2000).

³⁰ Entrepreneurs can repackaging returns to effort by paying themselves below-market salaries and earning capital gains on their stock. Analogous strategies are used when startups are funded by venture capitalists. See Ronald J. Gilson & David M. Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harv. L. Rev. 874 (2003). Likewise, taxpayers look for strategies to convert interest income to capital gain. See Code Sec. 1258 (targeting so-called “conversion” transactions). Even without these aggressive strategies, capital gain includes an interest-type return when taxpayers part with the use of their money, since a portion of their profit is for time value as opposed to risk. See generally Scarborough, *supra* note 3.

investments, the capital loss limitations do not constrain her timing option, which can be extremely valuable. She is likely to favor riskier investments, and her effective rate on them can be *negative*. While deferring any gains on these new investments, she can use losses to shelter the short-term hedge fund gain that she otherwise has to recognize. Thus, while the capital loss limitation constrains the timing option to an extent, a tough wash sale regime can make an important contribution here as well.

III. Perfect End-Runs Around the Wash Sale Regime

Needless to say, the wash sale rules do not serve as a backstop for the capital loss limitation – and, more generally, they do not enhance efficiency or equity – if Section 1091 is easy to avoid. It should not be possible, then, to replace loss positions with substitutes offering virtually the same economic return. This Article calls such a step a “perfect end run.” By tolerating perfect end runs, the system collects less revenue while favoring risky positions. In effect, we have a lower-of-cost-or-market (“LCM”) system, in which gains are deferred and losses are currently recognized. In important ways, though, perfect end runs can be *worse* than LCM: they require elaborately wasteful planning (an efficiency concern) and thus are open only to very wealthy taxpayers (a vertical equity concern). As a result, blocking perfect end runs should be uncontroversial. If we are going to have a wash sale regime, we need to fill these gaps.

This Part identifies seven perfect end runs.³¹ Like weeds, they spring up through cracks in a very old regime. After all, most of Section 1091’s operative provisions were drafted more than half a century before the over-the-counter derivatives market began to

³¹ Portions of this discussion are drawn from David M. Schizer, *The Taxation of Financial Instruments: Special Rules* (BNA Tax Management Portfolio) (forthcoming 2004). Readers desiring a more detailed discussion should consult the BNA portfolio.

develop. While end runs typically depend on close readings of language and technical distinctions, there is precedent for reading Section 1091 in this precise way.³² As a result, some of these strategies are endorsed by top law firms. This is not to say that all (or, for that matter, any) of these perfect end runs *clearly* work under current law. Section 1091 is an anti-abuse regime, which judges may (and certainly should) read broadly in light of the underlying policy. Yet aggressive taxpayers find ample room to maneuver here.³³ In response, the government should give clear guidance that these strategies do not work. In most of these cases, a revenue ruling will suffice.

A. (Arguable) Omission of Swaps

Since the main function of the wash sale rules is to curtail the timing option, the regime should apply to any investment subject to realization accounting that is liquid enough to permit strategic trading. There is less need for the regime in illiquid markets, since high transactions costs can discourage strategic trading.³⁴ Fortunately, most liquid investments are covered under the wash sale rules. As a technical matter, they qualify as

³² See, e.g., *S.H. Knox*, 33 BTA 972, Dec. 9210 (1936) (declining to find wash sale when taxpayers sell stock and acquire interests in private corporation that serves as holding company for this same stock); *W.P. Doyle*, CA-7, 61-1 USTC ¶ 9237, 286 F. 2d 654 (1961) (wash sale rules not triggered when taxpayer used a short sale to hedge a replacement position that he purchased before the window period began); for a discussion of *Doyle*, see *infra* note 49 and accompanying text; *David E. Gantner*, 91 TC 713 (1988), *aff'd*, 90-2 USTC ¶ 50,335, 905 F.2d 241 (8th Cir. 1990) (finding that regime did not apply when option was sold at a loss and replaced with another option during window period); for a discussion of *Gantner*, see *infra* note 39 and accompanying text.

³³ It is worth adding that these strategies generally are hard to identify on audit. The loss is real, since the taxpayer does indeed sell an investment at a loss. The auditor thus will need to ask the right questions about whether a replacement position has been acquired. Even if the transaction is audited, taxpayers have a good chance of avoiding penalties. They have a plausible technical argument, so the government might be expected to waive penalties in a settlement. The bottom line is that many taxpayers are tempted to play the “audit lottery.” For a discussion of this familiar tax-planning dynamic, see Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (1999).

³⁴ Consider a landlord whose building declines in value. It is difficult to deduct this loss if the landlord wants to keep the building. Since it is not fungible, the landlord cannot simply replace it with an identical one, as he could, for instance, with something that is publicly traded. In theory, he could sell the building to his daughter, but other rules disallow losses in related-party transactions. Alternatively, the landlord might try to sell the building and immediately buy it back. Yet with nonfungible property, the law of ownership is likely to keep him from claiming this loss, since he will not be parting with the economic benefits and burdens of ownership.

“stock or securities,” which are the magic words under Section 1091.³⁵ Yet even though derivatives can be quite liquid, these modern instruments have sometimes slipped through the cracks.³⁶

1. Derivatives as Loss Positions

The wash sale rules have been slow to treat derivatives as loss positions, waffling on the question of whether these instruments are “securities” within the meaning of Section 1091. The code does not define the term consistently. Sometimes it includes swaps, options, and forward contracts, but sometimes it does not.³⁷ The wash sale rules do not reference any of these other definitions. A number of authorities have grappled with the question, not necessarily consistently.³⁸ Then in 1988, the Tax Court concluded that options did not qualify as “securities,” and thus could not be loss positions.³⁹

³⁵ Thus, the regime properly extends to residual interests in Real Estate Mortgage Investment Conduits (REMICs), § 860F(d)(1), ownership interests in a Financial Asset Securitization Investment Trusts (FASITs), § 860L(f)(1), single-stock security futures, § 1091(f), and GNMA mortgage participation certificates, Gen. Couns. Mem. 39,551 (Aug. 26, 1986) (concluding that GNMA certificates are securities because prices are quoted daily, and so taxpayers could easily sell one and buy another to trigger a loss that has no economic consequences). It probably also extends to Treasury bill futures, see G.C.M. 38,369 (Dec. 3, 1980) (concluding that Treasury bill futures are securities because they are direct alternatives to investing in Treasury bills, which clearly are securities), although some commentators regard this G.C.M. as suspect. See, e.g., Andrea Kramer, *Financial Products Taxation, Regulation, and Design*, at 29-16 to 29-17 (3d ed. 2002 Supp.). The omission of commodities is discussed in Part III.F, *infra*.

³⁶ Derivatives obviously are liquid if traded on public exchanges. Over-the-counter instruments are also liquid, since securities dealers profit by keeping clients happy, and thus are likely to help them defer gains and accelerate losses. Since securities dealers mark their customer positions to market, they incur no tax cost in accommodating customer preferences as to timing. See David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339, 1367 (2000).

³⁷ Compare Sections 351(e), 475(c)(2), 731(c)(2) (explicitly mentioning forward contracts, notional principal contracts, and derivatives generally) with Sections 165(g)(2), 1083(f) and 1236(c) (no explicit reference to derivatives). Note that Section 1236(c)'s definition includes an “evidence of an interest in” stock, a phrase that arguably is broad enough to include derivatives. For a good discussion of this issue, see Lucy W. Farr & Michael S. Farber, *Dirty Linen: Airing Out the Wash Sale Rules*, *Taxation of Financial Products* 33 (Summer 2002).

³⁸ For instance, in holding that corn futures contracts are not securities, the Tax Court offered a broad rationale that seems to reach swaps and forwards as well:

All executory contracts giving a person the right to demand and receive property upon the payment of a contract price are not to be regarded as securities within the meaning of [the wash sale rules]. It is apparent . . . that such a future is not a security in any generally recognized sense but simply a contract between two parties in which one agrees to supply at a designated time in the

In response, Congress amended the statute in 1988 to ensure that options could qualify as loss positions. A final sentence was added to Section 1091(a): “For purposes of this section, the term ‘stock or securities’ shall, except as provided in regulations, include contracts or options to acquire or sell stock or securities.”⁴⁰ It is clear, then, that options qualify as loss positions. Physically-settled forward contracts also indisputably fall within the phrase “contracts . . . to acquire or sell stock or securities.”

However, this language arguably does not cover cash-settled forward contracts and swaps even though these instruments present the same potential for abuse: Since the underlying property does not change hands, nothing is “acquired.” The addition of Section 1091(f) in 2000 has helped resolve this issue: “This section shall not fail to apply to a contract or option to acquire or sell stock or securities solely by reason of the fact that the contract or option will settle in (or could be settled in) cash or property other than such stock or securities.” To paraphrase, cash settled contracts *can* qualify as “contracts to acquire.”

Nevertheless, some advisors still distinguish certain types of swap contracts – specifically, those on which fluctuations in the underlying property’s value are settled through periodic payments, instead of through a single payment at maturity.⁴¹ These

future a stated quantity and quality of goods, upon payment of a stated price and on which a part of the contract price, called a margin, has been paid by the buyer to his broker to bind him until the sale is consummated or the contract is sold.

Corn Products Refining Co., 16 TC 395, 399-400, Dec. 18,127 (1951), aff’d CA-2, 54-2 USTC ¶ 66,082, 215 F.2d 513 (1954), aff’d on other grounds, SCt, 55-2 USTC ¶ 9746, 350 U.S. 46, 76 SCt 20 (1955). But see *Trenton Cotton Seed Oil Co.*, CA-6, 45-1 USTC ¶ 9163, 147 F.2d 33 (1945) (concluding that a commodities future is a security).

³⁹ See *Gantner*, 91 TC 713 (1988), aff’d, 905 F.2d 241 (8th Cir. 1990).

⁴⁰ This language was added by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, Sec. 5075, 102 Stat. 3342 (1988).

⁴¹ For example, assume that on January 1, the taxpayer enters into the “long” position on an equity swap that is based on the value of 100 shares of XYZ. In economic effect, the swap causes the taxpayer to feel as if he has purchased the underlying shares with borrowed money. Thus, every quarter, the taxpayer

periodically-settled swaps are said to differ from cash-settled forward contracts, given the timing of their payments, and thus are not “contracts to acquire.”⁴² Indeed, there are other places within the Code where swaps and forward contracts are treated differently.⁴³ Guidance is needed (e.g., in a revenue ruling) to clarify that Section 1091(f) should not be read in this cramped way.

2. Derivatives as Replacement Positions

Similar issues arise in determining whether derivatives trigger the wash sale regime when they *replace* some other position that has been sold as a loss. The statute expressly applies when a taxpayer “has entered into a contract or option so to acquire, substantially identical stock or securities.” It is clear, then, that call options and physically settled forward contracts trigger the regime (as does the sale of a deep-in-the-money put option).⁴⁴ Cash-settled forward contracts are also expressly covered under Section 1091(f).

either (A) owes a payment based on any decline in the value of the XYZ shares during the quarter or (B) is entitled to a payment based on any increase in the value of XYZ shares during the quarter. In addition the taxpayer owes a quarterly payment based on prevailing interest rates and is entitled to a payment based on any dividends paid with respect to the XYZ shares. Thus, every quarter, the taxpayer either makes or receives a single payment, which is the “net” of the various payments described above. On December 30, after XYZ shares have declined during the quarter, the taxpayer pays a third party to take over the swap, thus realizing a loss. The next day, the taxpayer enters into a substantially identical swap contract.

⁴² These advisors concede that a swap is essentially no different from a cash-settled forward contract if the swap accounts for fluctuations in the underlying through a single payment at maturity, rather than through periodic payments.

⁴³ For example, a government ruling declines to treat notional principal contract as a series of cash settled forward contracts in determining the character of periodic payments. Priv. Ltr. Rul. 9730007 (Apr. 10, 1997). Likewise, the timing rules for notional principal contracts under Treas. Reg. 446-3 diverge from the simpler timing rules applicable to forward contracts. In addition, Section 1259 applies (slightly) different tests to notional principal contracts and contracts to acquire. Compare Code Sec. 1259(d)(3) with Code Sec. 1259(d)(4). Indeed, a number of provisions refer to notional principal contracts as instruments distinct from forward contracts. See e.g., Code Sec. 351(e)(1)(B)(ii); Code Sec 475(c)(2); Code Sec. 731(c)(2)(C); Code Sec. 956(c)(2)(j); Code Sec. 1233(h)(1).

⁴⁴ In Rev. Rul. 85-87, the government ruled that selling an in-the money put option would trigger the wash sale rules when there was “no substantial likelihood that the put would not be exercised.” Although the put is not a contract to acquire in form, “the put sold by A is in substance a contract to acquire stock.” Rev. Rul. 85-87, 1985-1 CB 268 (June 24, 1985). Cf. *G.I.C. Corp.*, DC Fl., 96-2 USTC ¶ 50,400 (S.D. Fla. 1996), *aff’d* on other grounds, CA-11, 97-2 USTC ¶ 50,672, 121 F. 3d 1447 (1997) (finding that taxpayer

Yet questions remain about periodic swaps, as discussed above. Some argue that the wash sale regime does not apply when a taxpayer sells ABC stock at a loss and enters into a total return periodic swap. This is a bizarre result, since a periodic swap offers virtually the same economic exposure as a share.⁴⁵ It obviously is inefficient to create a tax-based incentive to replace loss positions with periodic swaps. In addition, over-the-counter derivatives are available only to wealthy and sophisticated investors, an advantage that raises vertical equity concerns.

B. Doubling Up With a Hedged Position

Taxpayers use derivatives to exploit other technical glitches in the wash sale rules as well. In the periodic-swap strategy described above, the question is *whether* a taxpayer has acquired a replacement position (i.e., because periodic swaps arguably do not qualify). In contrast, a second strategy turns not on whether – but on when – a replacement position is acquired. This “when” question is relevant because a wash sale is triggered only if the replacement position is acquired during the window period.

There obviously is no wash sale if the replacement position is acquired *before* the window period begins. As an example of this familiar “doubling up” strategy, assume that a taxpayer plans to sell stock at a loss on November 1. If she buys stock before the wash sale period begins – for instance, on September 29 – her loss is not disallowed. In order to deduct the loss, then, she needs to double her investment for thirty-one days.

that sold stock and then sold a put option did not trigger a wash sale; facts of the case do not describe strike price of put option).

⁴⁵ There are two unimportant differences. First, a swap offers complete leverage. The taxpayer does not put any cash down, and thus feels as if he has purchased stock with 100% borrowed funds. But why should a difference in leverage affect whether the wash sale rules are triggered? Indeed, under current law, a wash sale is triggered if a taxpayer purchases a new share during the window period – whether or not the taxpayer borrows money to do so. Second, a swap exposes the taxpayer to counterparty credit risk. Yet in the usual case, where the counterparty is a securities dealer with a strong credit, this risk is economically unimportant. See *infra* Part III.E.

Yet taxpayers often do not want this extra exposure. Instead, they prefer to “double up” in form, but not in substance, by hedging the extra share they hold during the window period. If such hedging is allowed, taxpayers can claim their loss without changing their economic exposure in a meaningful way.

To begin with the simplest variation, which the wash sale regime explicitly forecloses, what if the taxpayer hedges with a short sale? For example, assume that the taxpayer owns one depreciated share with a basis of \$50. On September 29, she purchases a second share for \$30. On the same day, she sells a share short (i.e., by selling a borrowed share). More than a month later, on November 2, she “covers” the short sale with the depreciated share. In other words, she uses this share to settle up with the party that lent the shares sold in the short sale. Can the taxpayer recognize the \$20 loss?⁴⁶ Economically, the taxpayer feels as if he has owned one, and only one, share of stock for the entire period.⁴⁷ Yet, technically, do the wash sale rules apply?

The key question is whether the depreciated shares are treated as sold on November 2 (when the short sale is covered) or on September 29 (when the short sale is initiated). If the November date is used, then enough time has elapsed between this sale and the purchase of replacement property (i.e., on September 29). Absent a special rule, this would be the answer because, in general, a short sale is consummated for tax

⁴⁶ The tax loss at issue here will be \$20, regardless of the share price on the day the short sale is closed. The loss is the difference between (1) the \$50 purchase price of securities used to cover the short sale and (2) the \$30 of sale proceeds received when securities were sold initially (at the same time that they were borrowed). The share price at the time the short sale is covered does not figure into the analysis.

⁴⁷ The taxpayer starts out owning one share of stock. On September 29, the taxpayer buys a second share (which increases the exposure) and shorts a share (which correspondingly decreases the exposure), leaving the taxpayer, economically, as the owner of a single share. After the short sale is covered, moreover, only a single share remains.

purposes on the date it is covered, and not on the date it is initiated.⁴⁸ However, Treas. Reg. § 1.1091-1(g) blocks this result.⁴⁹ Under this regulation, the depreciated property is deemed sold – not when the short is *covered* – but when the short sale is initiated. In the above example, then, the depreciated stock is deemed sold (i.e., through the short sale) on September 29, which is the same day the new share is purchased.⁵⁰ Thus, the wash sale rules clearly apply.⁵¹

Although Treas. Reg. § 1.1091-1(g) keeps taxpayers from hedging with short sales, it does not explicitly address derivatives such as forward contracts, collars, and swaps, and some advisors contend that certain types of hedging are permissible. For

⁴⁸ Reg. § 1.1233-1(a); Rev. Rul. 73-524, 1973-2 CB 307. The constructive sale rule of Section 1259 is an exception to this general rule. It has no application to the facts here because the stock already owned by the taxpayer on the date of the short sale is not appreciated.

⁴⁹ The regulation thus overrides *W.P. Doyle, CA-7, 61-1 USTC ¶ 9237, 286 F. 2d 654 (1961)*, which found the wash sale rules to be inapplicable on similar facts. Reg. § 1.1091-1(g) provides: “For purposes of determining under this section the 61-day period applicable to a short sale of stock or securities, the principles of paragraph (a) of § 1.1233-1 for determining the consummation of a short sale shall generally apply except that the date of entering into the short sale shall be deemed to be the date of sale if, on the date of entering into the short sale, the taxpayer owns (or on or before such date has entered into a contract or option to acquire) stock or securities identical to those sold short and subsequently delivers such stock or securities to close the short sale.”

⁵⁰ The wash sale rules still apply, moreover, if the short is covered with newly-acquired shares, instead of with depreciated property. For instance, assume again that a taxpayer owns one depreciated share with a basis of \$50 and, on September 29, purchases a second share for \$30 and sells a share short. Unlike in the above example, however, the taxpayer does not use the depreciated share to cover the short. Instead, on November 2, the taxpayer buys a share at the market price (e.g., for \$30, assuming the market price has not changed), and uses this newly-acquired share to cover the short. On the same day, the taxpayer also sells the depreciated share for the market price, realizing a loss. On these facts, Reg. § 1.1091-1(g) does not apply, since the taxpayer does not “subsequently delive[r] such [depreciated] stock or securities to close the short sale.” But Section 1091(a) should apply because the taxpayer is selling the depreciated stock on the same day that he is buying new stock to cover the short (i.e., on November 2).

⁵¹ Taxpayers sometimes offer another technical argument to avoid a wash sale: Since the loss is incurred on a short sale (i.e., when the depreciated shares are used to cover the short), it is argued, the special wash sale rule for short sales, Section 1091(e), should govern. Yet this special rule finds a wash sale only when a short sale is paired with either a second short sale or with a sale of stock – and, evidently, not when a short sale is paired with a *purchase* of stock. See 1091(e) (disallowing loss on short sale if, within window period, “(1) substantially identical stock or securities were sold, or (2) another short sale of (or securities future contract to sell) substantially identical stock or securities was entered into”). Here, of course, the near-in-time transaction is a purchase. In response, though, the government might assert that the loss is disallowed, not under the special rule for short sales in Section 1091(e), but under the general rule of Section 1091(a). The language of Section 1091(a) should be broad enough to cover a short sale. See Section 1091(a) (“In the case of *any loss* claimed to have been sustained from *any sale* or other disposition of shares of stock or securities . . .”) (emphasis added).

instance, assume again that the taxpayer owns one depreciated share with a basis of \$50 and, on September 29, purchases a second share for \$30. On the same day, instead of selling a share short, she enters into a short “periodic” equity swap, through which she pays amounts based on appreciation in the stock and receives amounts based on depreciation in the stock. On November 2, she terminates the swap and sells the depreciated share.

Although the economic effect is that she has been “long” one (and only one) share during the entire period, some advisors argue that this transaction does not trigger a wash sale. The claim is that Treas. Reg. § 1.1091-1(g) does not apply because a periodic swap is formally different from a short sale.⁵² In response, more conservative advisors offer reasons why the wash sale rules could still apply on these facts, including Section 1233,⁵³ business purpose,⁵⁴ an old revenue ruling,⁵⁵ and the holding period rules.⁵⁶ Yet there is

⁵² There are two adverse consequences if the swap is deemed to be a “short sale” for purposes of Section 1091. Not only could Treas. Reg. § 1.1091-1(g) apply, but Section 1091(e) could also apply if the swap is terminated at a loss. If so, a short sale would be terminated at a loss (i.e., the termination of the swap on November 2), and substantially identical stocks or securities would be sold within the window period (i.e., the sale of depreciated stock on November 2).

⁵³ Although a short sale is formally different from a swap, the two obviously are economically similar. As a technical matter, is there authority for construing the term “short sale” broadly? Under Section 1233(b), which addresses the tax treatment of short sales, a “short sale” is defined to include a put option. This language might be an avenue by which the government seeks to read the term “short sale” as including other derivatives. See also *Hoover Co.*, 72 TC 206 (1979) (treating “short” currency forward contract as “short sale” for purposes of Section 1233). The taxpayer might respond that this definition in Section 1233(b) is expressly limited in scope, applying only “[f]or purposes of this subsection [1233(b)]” – and, it is argued, not for purposes of Section 1091. Yet this argument is somewhat weakened by the fact that Treas. Reg. § 1.1091-1(g) draws on the principles of Section 1233 and applies them (with a modification) in the wash sale context. See Treas. Reg. § 1.1091-1(g) (noting that “the principles of paragraph (a) of 1.1233-1 for determining the consummation of a short sale shall generally apply except that the date of entering into the short sale shall be deemed to be the date of sale” if certain conditions are satisfied). But even if the swap is a “short sale” for these purposes, the taxpayer has a further technical argument. The regulation applies only if the taxpayer “subsequently delivers such [depreciated] stock or securities to close the short sale,” something that obviously would not be the case in a cash-settled swap.

⁵⁴ The government might question the business purpose of purchasing stock and entering into a short swap on the same day. But what if the two steps are separated by a few hours – or, for that matter, by two days?

⁵⁵ Rev. Rul. 59-418 addresses similar facts, except that the taxpayer hedges with a forward contract instead of a swap. The ruling disallows the loss by treating the stock as if it is sold on the date on which the forward contract is initiated (i.e., September 29, in the above example), and not on the date that the shares

uncertainty on these issues, and some advisors take the view that transactions like these “work.” As a result, clear guidance (e.g., in a revenue ruling) is needed that hedging-based end runs are not permissible.

C. Out of the Money Call Options

The two derivatives-based end runs described above game the rules concerning *whether* and *when* a replacement position has been acquired. Not surprisingly, there also is a perfect end run concerning *which* new position qualifies as the replacement position. Ironically, the goal of this strategy is to *trigger* a wash sale – but to trigger it with the purchase of a deep out-of-the-money option, in effect clearing the way for the purchase of a “real” replacement position. The following example illustrates the advantage of this deliberate wash sale. If all goes according to plan, the taxpayer claims a deductible loss without materially changing her economic position.

ultimately are delivered (i.e., November 2, in the above example). According to the ruling, “[t]he taxpayer, as of [the date on which the forward contract was entered into], owned specific shares which he intended to sell. Moreover, such intent was subsequently confirmed by the delivery of those shares. On [the date on which the forward contract was entered into], his obligation became fixed. His loss was then realized, for he had transferred his equitable interests in the stock.” Rev. Rul. 59-418, 1959-2 CB 184. Tax advisors distinguish this ruling, though, because it involves a forward contract instead of a swap. They also argue that it should be read narrowly (or disregarded entirely) because its analysis of the law of ownership is out of step with other precedents; entering into a forward contract to sell fungible property is not usually considered a sale of such property under common law. See Rev. Rul. 03-7, IRB 2003-5, 363 (Feb. 3, 2003) (finding no constructive sale where taxpayer enters into variable delivery forward contract); see generally Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 *Taxes* 783 (1993).

⁵⁶ The government might claim that the newly-purchased share was not purchased, in substance, until the swap was terminated. In other words, the purchase date should be viewed, for purposes of Section 1091, as November 2, instead of September 29. If so, the sale of the depreciated property and the purchase of the new share would be deemed to occur on the same day (i.e., November 2). In other words, even if the government fails to establish that the loss position has been sold on the *earlier* date, the government can argue, in the alternative, that the replacement property has not been purchased until the *later* date. As support for this tolling of new property’s holding period until the equity swap is settled, the government might invoke the holding period rule under the straddle rules. Cf. Proposed Reg. § 1.1092(d)-2(d)(ii) (example) (treating a swap and stock as a straddle). Under Temporary Reg. § 1.1092(b)-2T, “the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds . . . an offsetting position with respect to that position.” However, although the straddle rules clearly toll holding period for purposes of computing capital gains, it is not clear that the straddle rules toll holding period for purposes of the *wash sale rules*.

Assume that the taxpayer sells 1000 shares of depreciated stock (the “old lot”) for \$70 per share on November 1, realizing a loss of \$100,000. If taxpayer purchases 1000 new shares (the “new lot”) the next day, she obviously cannot deduct this loss. But what if she adds a step? On November 1 – minutes after she sells the old lot, and the day before she buys the new one – the taxpayer buys out-of-the-money call options, entitling her to buy one thousand shares for \$400 per share on December 11 (forty days later). Because the options have a short term and are deep-out-of-the-money, the premium is very modest (e.g., 0.30 per share or \$300). Then, on November 2, she buys the new lot of stock.

What is the advantage of buying these out-of-the-money options before buying the new stock? The point is to add a second acquisition within the wash sale period. This strategy rests on the idea that only one of these acquisitions triggers a wash sale, and thus inherits the disallowed loss as additional basis.⁵⁷ Under current law, chronological order decides the question.⁵⁸ Since the options are acquired first, the taxpayer claims that the options trigger the wash sale.⁵⁹ The taxpayer’s argument, then, is that the basis in the option increases by \$100,000 (i.e., to \$100,300).⁶⁰ Assuming the option expires forty

⁵⁷ See Code Sec. 1091(d).

⁵⁸ See Reg. § 1.1091-1(d) (“Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.”).

⁵⁹ While the regulatory language looks to which position is “acquired” first, the term “acquired” should include the acquisition of an option. In other words, the relevant acquisition date should be the purchase – and not the exercise – of the option. See Reg. § 1.1091-1(f) (“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, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.”).

⁶⁰ There is a possible glitch in this argument, though. Some advisors read Section 1091(d) to say that, if an option triggers a wash sale, the basis from the loss position does not go directly into the option; rather,

days later, on December 12, the taxpayer hopes to deduct this \$100,300 loss in the current year – even though she purchased a new lot of stock a day after selling the old lot of stock.⁶¹ Of course, the loss would not be deductible if expiration of the option was *itself* a wash sale. Happily for the taxpayer, though, there are two reasons why Section 1091 seems not to apply when the option expires. First, the purchase of stock on November 2 is more than thirty-one days before the option expires (i.e., on December 11).⁶² Second, the stock in the new lot is not substantially identical to the option (i.e., since the option is out-of-the-money).⁶³

it goes to the stock or securities *acquired with* the option. Under this reading, the option does not inherit the basis from the depreciated stock, and thus the taxpayer cannot deduct this loss when the option expires. I am indebted to Erika Nijenhuis for this observation.

⁶¹ See Code Sec. 1234(a)(2) (“[I]f loss is attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired.”).

⁶² Another technical issue is whether lapse of an option qualifies as a “sale or other disposition” under Section 1091(a). Section 1234(a)(2) can be read to give an affirmative answer, providing that a lapsed option “shall be deemed to have been sold or exchanged on the day it expired.” Yet this argument is undermined, to an extent, by the fact that Section 1234(a)(2) begins with the qualifier “[f]or purposes of paragraph (1).” Paragraph (1) relates to the character of gain or loss on an option.

⁶³ There is an asymmetry in applying the “substantially identical” test to stock and options. According to Rev. Rul. 56-406,

If an individual taxpayer, who is not a dealer in stocks or securities, sells common stock of a corporation at a loss and simultaneously purchases warrants for common stock of the same corporation, the loss is not allowable by reason of section 1091(a) of the [Code]. If the taxpayer sells stock warrants of a corporation at a loss and simultaneously purchases common stock of the same corporation, the loss is allowable unless the relative values and price changes are so similar as to make the warrants fully convertible securities and therefore substantially identical with the shares of common stock.

1956-2 CB 523; see also Gen. Couns. Mem. 39036 (Sept. 16, 1983) (rejecting proposition that wash sale is always triggered when taxpayer sells a warrant at a loss and purchases stock within window period). In contrast, if stock is sold at a loss, and an option is purchased, the option and the stock do *not* have to be substantially identical. See Section 1091(a) (finding a wash sale if, first, there is “any sale or other disposition of shares of stock” and, second, within the wash sale period the taxpayer has “entered into a contract or option so to acquire” substantially identical stock and securities). Thus, in the sale-of-stock scenario, what matters is the option’s *underlying* property, and not the option itself.

Although there may be room to read the language differently, the last sentence of Section 1091(a) should not change this result, even though it was added after the above ruling was issued. This last sentence treats options as “stock or securities.” Thus, if an option is sold at a loss, the wash sale rules apply if substantially identical “stock or securities” – read *options* – are acquired. The regime also could be triggered by a contract or option to acquire the relevant underlying property, but in this case the relevant underlying is the option itself; so this trigger seems to be an option to buy a substantially identical *option*.

If this strategy “works,” the net effect is that the taxpayer replaces the old stock with new stock almost immediately, but still deducts the loss. The price of circumventing Section 1091 is a modest expenditure on economically insubstantial options. Yet the words “economically insubstantial” are worth emphasizing. This strategy is less obviously an end run around current law – and thus is less attractive to taxpayers and less objectionable to the government – if the options represent a genuine investment. Indeed, if the taxpayer buys in-the-money options with long terms, the transaction becomes a version of the traditional doubling up strategy – with the (relatively unimportant) variation that the taxpayer holds options instead of extra stock.⁶⁴ A key problem here, then, is that the option is not economically meaningful and thus should lack business purpose under current law. Yet advisors obviously vary in their judgments about business purpose, and some are willing to bless aggressive transactions. As a result, clearer guidance is needed here. For instance, the government could use a revenue ruling to target deep out-of-the-money options on business purpose grounds.⁶⁵

D. Replacing Short Sales with Short Over-the-Counter Derivatives

In still another derivatives-based end run, some believe the wash sale regime is also underinclusive in its treatment of short positions. A special provision, Section

⁶⁴ Thus, if the taxpayer has 1000 shares of depreciated stock, he can clearly claim the loss by purchasing an additional 1000 shares – and thus holding 2000 shares – during the thirty days before he sells the depreciated stock. So why shouldn’t he be able to purchase 1000 economically “real” options – so that he holds 1000 options and 1000 shares – for thirty days? If the options are economically substantial, the taxpayer is doubling up in much the same way as if he’d purchased extra stock.

⁶⁵ A broader alternative is to change the ordering rule of Reg. § 1.1091-1(d). Instead of treating the first replacement position as the one that triggers the wash sale – regardless of whether this position is an option or stock – the rule could give priority to “delta-one” positions (such as stock, forward contracts, and swaps) over options. In other words, if any stock, forward contracts or swaps are acquired during the window period, the first of these to be acquired would trigger the wash sale (even if an option was acquired first). Thus, options would trigger wash sales only if no stock, forward contracts or swaps were acquired during the window period; in this scenario, the first option to be acquired would trigger the wash sale. At the same time that the government clarifies this regulation, they should also clarify that, if an option triggers a wash sale, it should inherit basis from the loss position. As noted above, some advisers believe the status of this basis is unclear. See *supra* note 60.

1091(e), governs wash sales involving short sales.⁶⁶ This provision finds a wash sale if, within the wash sale period, “another short sale of (or securities future contract to sell) substantially identical stock or securities was entered into.”⁶⁷

What if an unprofitable short sale is replaced with an over-the-counter short forward contract or swap? These contracts offer near perfect replication of a short sale, aside from credit, leverage, and liquidity issues. Even so, some advisors believe the wash sale rules do not apply for two reasons. First, they conclude that the short sale rule of Section 1091(e) does not reach over-the-counter derivatives on the theory that these instruments are not “short sales.” Indeed, these advisors emphasize that Section 1091(e) was amended to add securities futures – a step that was needed, they argue, because securities futures are different from short sales. If securities futures are different, then over-the-counter derivatives arguably are different too. But this amendment did not also add over-the-counter derivatives, a negative pregnant that gives these advisors comfort.⁶⁸

Second, some advisors conclude that Section 1091(a) does not reach these instruments. Even if Section 1091(e) doesn’t apply, Section 1091(a) would still find a

⁶⁶ Section 1091(e) provides: “Rules similar to the rules of subsection (a) shall apply to any loss realized on the closing of a short sale of . . . stock or securities if, within a period beginning 30 days before the date of such closing and ending 30 days after such date (1) substantially identical stock or securities were sold, or (2) another short sale of . . . substantially identical stock or securities was entered into.”

⁶⁷ Section 1091(e) also covers a straddle-type transaction similar to the abuse targeted by Section 1092. Assume that on January 1 a taxpayer purchases a share of stock and simultaneously shorts the stock. As a result, the taxpayer has two perfectly offsetting positions. Over the course of the year, the stock appreciates, giving the taxpayer a loss on the short sale and a corresponding gain on the long (i.e., the stock the taxpayer owns). On December 31, the taxpayer buys new stock and closes out the short sale at a loss. On January 1, the taxpayer sells the appreciated long position. The taxpayer obviously would like to claim the loss this year, while putting off the gain until next year. Yet Section 1091(e)(1) defers the loss. The taxpayer has covered a short at a loss and, within the wash sale period, “substantially identical stock or securities were sold.” See James W. Wetzler, *The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984*, 25 Tax Notes 453, 469-70, 472-73 (Oct. 29, 1984).

⁶⁸ In response, the government might invoke Section 1233(b), which treats certain put options as short sales. Assuming this principle of Section 1233 extends to Section 1091 – a controversial proposition, as noted above, see supra note 53 – the government would then have to show that over-the-counter derivatives qualify as put options for purposes of Section 1233. Cf. *Hoover Co.*, 72 TC 206 (1979) (“short” foreign currency contracts treated as short sales for purposes of Section 1233).

wash sale if the taxpayer “acquires” a “stock or security” upon entering into these instruments. Yet some authorities suggest that short positions cannot be “acquired” because they are not assets.⁶⁹ Other advisors disagree, noting that the statute specifically includes “contracts . . . to sell stock or securities” in the definition of “stock or securities.”⁷⁰ Needless to say, the regime should reach these transactions, and guidance (e.g., in a ruling) is needed to ensure that it does.

E. Credit Risk

While the first four perfect end runs deal with derivative securities, the fifth has somewhat broader application: Aggressive taxpayers sometimes give too much weight to minor differences in credit risk between the loss and replacement positions. This strategy relies on very old authorities concerning debt securities, a risky strategy since modern courts may well reject these old fashioned precedents (or, at least, may resist applying them to investments that are not debt).⁷¹ Under the statute, a wash sale is triggered if the replacement position is “substantially identical” to the loss position.⁷² Some courts have read the “substantially identical” standard to require an extremely close economic

⁶⁹ There is authority that short call options cannot be “acquired.” See, e.g., TAM 7730002 (Apr. 14, 1977) (Section 1091 does not apply when option grantor terminates an option because grantor does not “acquire” property); Priv. Rul. 8517029 (Jan. 29, 1985) (Section 1234, not Section 1091, provides rule when option grantor terminates call option). Yet a possible distinction is that a short call option can *only* be a liability, generating losses as the stock price rises, but not making money, other than the premium, as the stock price falls. While a short forward contract or short equity swap can be a liability if the stock price rises, these contracts also can prove to be assets if the stock price falls.

⁷⁰ See Code Sec. 1091(a).

⁷¹ I thank Erika Nijenhuis for this observation.

⁷² In addition to Section 1091, where this standard is not defined, the phrase “substantially identical” also is used in the rules for short sales under Section 1233, which prevent taxpayers from aging property while at the same time shorting “substantially identical” property. According to Treas. Reg. § 1.1233-1(d)(1), which defines the term, the phrase generally has the same meaning in both contexts. Reg. § 1.1233-1(d)(1) (“In general, as applied to stocks or securities, the term has the same meaning as the term substantially identical stock or securities used in section 1091, relating to wash sales of stocks or securities.”). See also Rev. Rul. 77-201, 1977-1 CB 250 (noting that Reg. § 1.1233-1(d) “defin[es] the term ‘substantially identical property’ for purposes of section 1091 of the Code”). Likewise, the test is used in the regime governing the dividends-received-deduction, in which taxpayers are barred from claiming this benefit if they hedge with a position in “substantially identical” property. Code Sec. 246(c)(4).

similarity. Thus, differences in collateral have caused two debt securities not to be substantially identical.⁷³ Similarly, the fact that securities are issued by formally different entities has been adequate to avoid a wash sale, even when the securities are all guaranteed by the federal government.⁷⁴

This is not to say that credit risk should never be relevant. Obviously, a taxpayer who replaces a Treasury with a junk bond is significantly changing her economic position, and thus is not engaging in a perfect end run.⁷⁵ Yet credit risk is unimportant if the relevant credits are roughly comparable. For instance, a taxpayer might replace a call option purchased from Morgan Stanley with one purchased from Goldman Sachs. Similarly, a taxpayer might replace an over-the-counter forward contract with an

⁷³ See *Hanlin*, CA-3, 39-2 USTC ¶ 9783, 108 F.2d 429 (1939), aff'g 38 BTA 811 (1938). In *Hanlin*, the taxpayer replaced bonds of the Federal Land Bank of Louisville with bonds of the Federal Land Banks of St. Louis and Wichita. The formal difference in issuers was deemed immaterial, since the various land banks were “all under the supervision of one central authority,” the U.S. Farm Credit Administration, and since the banks were “at least secondarily liable on each other’s bonds.” *Id.* at 430-31. Rather, the key difference in these bonds, which rendered them not substantially identical, was that they were backed by different collateral – in one case, mortgages on *Louisville* farms, and, in the other, mortgages on *Wichita* farms. “Though the average sense of the obligation may well be the same, even an economist must recognize, by geographical definition, a salient divergence in, say the type (and marketability) of crops produced – or, perhaps, the likelihood of dust storms,” the court said. “This difference, we think, deprives the bonds of one Land Bank of substantial identity with those of another.” *Id.* at 431. Compare TAM 8641004 (June 30, 1986) (GNMA certificates considered substantially identical, notwithstanding differences in underlying mortgage pools, because average properties of pools tend to be the same).

⁷⁴ In Rev. Rule 59-44, 1959-1 CB 205, bonds of certain local housing authorities were replaced by bonds of other housing authorities, but all these housing authorities had some degree of credit support from a central federal housing authority. The question was whether this federal authority was “common primary obligor on all the bonds involved,” such that the bonds should be treated as, in effect, having a single issuer. The ruling concluded that the formal differences in the issuers had economic substance, and that the federal backstopping role was incomplete, largely because the federal guarantee did not apply to the extent that income from the underlying collateral (i.e., rental properties) was adequate to cover payments owed to bond investors. “[T]he local authorities have very substantial credit standings of their own . . . in view of their ownership of the housing projects and the requirement that the net revenues derived therefrom become a part of the debt service fund,” the ruling noted. In addition, “the various local authorities are separate political entities unassociated with each other and with no secondary liability with respect to each other’s bonds,” a fact that distinguished the ruling from *Hanlin*. *Id.* Compare TAM 8641004 (June 30, 1986) (GNMA certificates considered substantially identical, notwithstanding differences in underlying mortgage pools, because average properties of pools tend to be the same).

⁷⁵ As a result, the question whether a wash sale should be triggered depends on the question of how strong the regime ought to be – that is, how readily the system should disallow losses. This general issue is considered in Part IV, although the treatment of debt is beyond this Article’s scope.

exchange-traded securities future.⁷⁶ Assuming the term and strike prices of these pairs of positions are the same, the main difference is credit risk. Likewise, a taxpayer might replace one indexed mutual fund with another. Even if both are based on the same index (e.g., the S&P 500), so that they offer virtually identical economic returns,⁷⁷ the two funds involve formally different credit risks: they are distinct entities, and may be managed by different management companies (e.g., Vanguard versus Fidelity).⁷⁸ Thus, if someone slips and falls in one office, but not in another, the tort judgment will modestly affect economic returns.⁷⁹

The reality is that investors are unlikely to notice such differences. After all, how often is a regulated securities dealer's credit so poor that it cannot honor a contract? Aggressive taxpayers should not be able to invoke these minor differences to avoid a wash sale. The government should issue guidance (e.g., in a ruling) that credit risk is not taken into account under Section 1091 for derivatives or equity-based mutual funds when the relevant credits are comparable.

⁷⁶ For a discussion of securities futures, See Erika W. Nijenhuis, *New Tax Rules for Securities Futures Contracts Enacted*, 14 J. Tax'n Fin. Inst. 4, 117-18 (May/ June 2001).

⁷⁷ Very minor differences in economic return are possible. The funds may have different fee structures. In addition, they may be more or less prompt in adjusting to changes in the underlying index.

⁷⁸ Instead of conceptualizing this as credit risk, we might also view it as firm-specific risk in a context where firm-specific risk is unimportant. In any event, there is old authority that such differences are enough to defeat a wash sale. See *Seymour H. Knox*, 33 BTA 972 (1936) (declining to find a wash sale when taxpayers sell stock and acquire interests in corporation that serves as holding company for such stock because "[t]he separateness of a corporation and its stockholders can not be disregarded for this purpose"). But cf. *Security First Nat'l Bank of Los Angeles*, 28 BTA 289, 313-15 (1933) (deeming wash sale regime to apply when a trust controlled by the selling taxpayer repurchased the securities).

⁷⁹ Admittedly, this difference is becoming somewhat more significant as regulators investigate (and fine) some funds, but not others, for trading improprieties.

F. Omission of Commodities

The regime also is underinclusive in omitting commodities or commodities-based derivatives. Technically, these instruments do not qualify as “stock” or “securities.”⁸⁰ This omission is unimportant for exchange-traded commodities futures since these are marked to market under Section 1256. But commodities themselves, and also over-the-counter commodities derivatives, are not marked to market. Although investing directly in commodities is not always easy, since significant transactions costs are sometimes involved, this market may still be liquid enough to permit strategic trading. To reach commodities, a statutory amendment probably is needed.⁸¹

G. Omission of a Related Party Rule

The final gap is that Section 1091 does not have a related party rule.⁸² For example, assume that a taxpayer sells stock at a loss on December 31 and, on the same day, his wife buys the stock. Under a literal reading of the statute, there is no wash sale. The statute does not explicitly require husbands and wives (or, for that matter, parents and children, or entities and their owners) to be treated as one taxpayer for these purposes.

⁸⁰ See Rev. Rul. 71-568, 1971-2 CB 312 (concluding that Section 1091 does not apply to commodity futures); Gen. Couns. Mem. 34630 (Oct. 4, 1971). In drawing this conclusion, the I.R.S. declined to follow *Trenton Cotton Seed Oil Co.*, CA-6, 45-1 USTC ¶ 9163, 147 F.2d 33 (1945), which held to the contrary. But other courts have held that commodity future contracts are not securities. See, e.g., *Corn Products Refining Co.*, CA-2, 54-2 USTC ¶ 66082, 215 F.2d 513 (1954), aff’d on other grounds, SCt, 55-2 USTC ¶ 9746, 350 US 46, 76 SCt 20 (1955); *Sicanoff Vegetable Oil Corp.*, 27 TC 1056 (1957), rev’d on other grounds CA-7, 58-1 USTC ¶ 9233, 251 F.2d 764 (1958).

⁸¹ Section 1091 also does not apply to foreign currency. See Rev. Rul. 74-218, 1974-1 CB 202. Although this market is liquid enough to support strategic trading, this omission is necessary, since it would be difficult to apply the wash sale regime in a way that was not dramatically overbroad. In a global economy, taxpayers engage in currency transactions all the time. Indeed, whenever a U.S. taxpayer engages in a transaction denominated in a foreign currency, the tax law conceptualizes it as a bet on the currency, as well as a transaction in the underlying goods or services. See generally Code Sec. 988. Matching these transactions and disallowing losses would be administratively difficult, and could discourage cross border transactions (e.g., if currency gains were immediately recognized but currency losses were not).

⁸² In contrast, Section 1092 and Section 1259 do have related party rules.

To a significant extent, courts have filled this gap. They sometimes have invoked Section 267, which disallows losses in sales “directly or indirectly” to related parties.⁸³ In other cases, courts have fashioned a common law of wash sales, holding that not enough has changed in the taxpayer’s situation to justify a tax deduction.⁸⁴ Although this judicial gap-filling has been helpful, the cases are fact-specific, and sometimes are in tension with each other.⁸⁵ As a result, a statutory amendment adding a related party rule would be helpful (though, perhaps, not essential).

H. Remediating Obvious Overbreadth: Going from Short to Long

So far, this Part has focused on instances in which the wash sale rules are obviously underinclusive. In contrast, this Section focuses on the opposite problem: an

⁸³ Even though, in form, the taxpayer is selling to a third party (e.g., to the market through a broker), the related party is purchasing at the same time (e.g., in the same market through the same broker). Thus, the transaction has been treated as, in substance, between the two related parties. See, e.g., *McWilliams*, SCt, 47-1 USTC ¶ 9289, 331 U.S. 694 (1947) (loss disallowed under predecessor of Section 267 where husband directed broker to sell stock in the market and, at the same time, instructed the broker to buy stock in the market for his wife’s account). If applicable, Section 267 imposes a harsher penalty than Section 1091. Under Section 267, the disallowed loss generally is not added to the basis of the acquired property, and holding period is not tacked. Although this disallowed loss may be used to reduce the purchaser’s *gain*, this loss cannot be used to increase the purchaser’s *loss*. An exception is provided for controlled groups of corporations. See Code Sec. 267(f)(2).

⁸⁴ See, e.g., *Smith*, SCt, 40-1 USTC ¶ 9160, 308 U.S. 473, 477-80, 60 SCt 355 (1940) (invoking “sham transaction” principles to disallow loss when taxpayer sold depreciated asset to controlled corporation); *J. Karr*, CA-11, 91-1 USTC ¶ 50,113, 924 F.2d 1018, 1022-23 (1991), aff’g *D.B. Smith*, 91 TC 733 (1988).

⁸⁵ For instance, repurchases by a spouse do not always trigger a wash sale. If the purchasing spouse acts on her own initiative, using her own means, the selling spouse’s loss should not be disallowed. *D.B. Young*, 34 BTA 648, 652-53 (1936); *T.W. Behan*, 32 BTA 1088, 1091-92 (1935). In contrast, losses are likely to be disallowed if the selling spouse exercises “dominion and control” over securities nominally purchased by the other spouse. *Estate of E.W. Mitchell*, 37 BTA 161, 166-67 (1938) (finding that husband exercised “dominion and control” over the securities bought by his wife, and thus holding that husband could not claim loss on identical securities he had sold); *G.E. Morse*, 34 BTA 943, 945-46 (1936) (same). Thus, it is a bad fact for the selling spouse to place the order or to supply the funds, even if the repurchase is for the other spouse’s account. *J.W. Singer*, 32 BTA 177, 180 (1935); *D.A. Belden*, 30 BTA 601, 603-04 (1934); *W.E. Bronchon*, 30 BTA 404, 404-07 (1934). In addition, parents and children tend to be treated more leniently than spouses, as are siblings. See, e.g., *Cole v. Helborn*, 4 F. Supp. 230 (W.D. Ky. 1933) (permitting father to deduct loss even though he loaned money to son so that son could purchase the same securities the day after father sold them); *Johnston*, CA-6, 40-1 USTC ¶ 9108, 107 F.2d 883, 884 (1939) (allowing brother to claim loss on sale of securities, even though brother gifted sale proceeds to sister, and then sister used this money to purchase the same securities). In any event, some believe the old cases in this footnote may no longer good law, given the Supreme Court’s approach in *McWilliams*, 47-1 USTC 9289, supra note 83, but the precise reach of the *McWilliams* case is unclear.

instance in which the regime is obviously overinclusive. Notwithstanding this change in focus, this issue is connected to the preceding discussion; like the other glitches identified in this Part, the need to reform this one should be uncontroversial.

A special rule, Section 1091(e), is needed to govern short sales because the main wash sale provision, Section 1091(a), does not reach a taxpayer who closes a short sale at a loss and immediately enters into a new short sale. Section 1091(a) is triggered only if a taxpayer *acquires* stock or securities during the window period, but not if she *sells* stock or securities.⁸⁶

Unfortunately, Section 1091(a) is also *overinclusive* as applied to short sales. As a technical matter, it seems to apply to a taxpayer who closes a short sale at a loss and decides to purchase additional stock as a “long.” For example, assume that a taxpayer has shorted stock at \$60 and, on December 1, when the stock is trading at \$100, she purchases new stock and covers the short, realizing a loss of \$40. Expecting the stock to appreciate further, the taxpayer purchases additional stock on December 2. As a policy matter, this transaction does not present the wash sale abuse. Although the tax loss is triggered, the taxpayer is fundamentally changing the economic bet by shifting from short to long. Even so, technically, Section 1091(a) seems to apply. There is “loss claimed to have been sustained from any sale” (i.e., the short sale), and the taxpayer has purchased stock a day later.⁸⁷ Since this result makes no sense, the government should clarify (e.g., in a ruling) that the statute should not be read in this way.⁸⁸

⁸⁶ Section 1091(a) is triggered if “the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities.”

⁸⁷ To avoid this result, some taxpayers take the position that Section 1091(e) is the exclusive rule for short sales, but the “any sale” language of Section 1091(a) does not square easily with this reading.

⁸⁸ Section 1091(a) arguably yields another bizarre result for short sales, although revenue rulings offer some comfort on the issue. Arguably, Section 1091(a) applies *any time* a short sale is covered at a loss

IV. The Case for a Stronger Wash Sale Regime

The prior Part offered eight reforms that should be uncontroversial: seven perfect end runs that should be blocked, and an obvious instance of overbreadth that should be corrected. The unifying theme so far is that no deduction should be allowed if taxpayers have not changed their economic position at all – or, at least, not in a noticeable way.

This Part makes a more controversial argument: Even if taxpayers *do* change their economic position in a meaningful way, their loss should still be disallowed as long as this change is incomplete. The key question should be whether material elements of the old economic return remain. Why should loss deferral be this broad? This Part offers two justifications: first, losses need to be deferred because gains can be deferred quite easily under current law; second, a loss deferral rule is counterproductive if taxpayers can avoid it easily. Drawing on these general principles, this Part develops a theory about the proper scope of the wash sale rules. Happily, current law already reaches the correct result in important cases, but other aspects of current law need to be changed.

This case for changing current law is subject to a caveat, though. There is a risk that the wash sale regime might never be tough enough to be effective. Taxpayers might continue harvesting losses, while choosing replacement positions that are sufficiently unlike the loss position. If this would be a widespread reaction, other constraints on the

with newly acquired stock – even if the taxpayer does not also enter into a second short sale. For example, assume that a taxpayer sells stock short for \$100 on January 1. On March 1, she buys stock for \$120 and covers the short at a \$20 loss. On March 1, she has both sold stock at a loss and acquired stock (but, obviously, has not engaged in any strategic trading). Should this purchase be viewed as an “acquisition” that triggers a wash sale? Rulings suggest that this odd result should not be the answer. See Rev. Rul. 56-602, 1956-2 CB 527 (holding that wash sale rules do not apply when taxpayer purchases property and sells it at a loss within 30 days); Priv. Rul. 8517029 (Jan. 29, 1985) (holding that purchase of a call to cover a short call position is subject to Section 1234, not Section 1091).

timing option might be preferable, including a broader capital loss limitation or more accelerated timing for gains.

A. How Aggressively Should Our Realization-Based System Defer Losses?

1. The Parity Goal

In determining how aggressively to defer losses, policymakers should start by matching the treatment of losses with the treatment of gains. An important problem with the timing option, discussed in Part II, is that the effective tax rate on gains becomes lower than the effective tax rate on losses: in other words, the government shares disproportionately in losses. As a result, the government loses revenue and the tax burden on (wealthy) investors declines. In addition, taxpayers have the incentive to prefer risky positions *ex ante*, and to engage in wasteful tax planning *ex post*. To solve these problems, the government's share of gains needs to match its share of losses. This parity goal means that, if taxpayers can easily defer the tax on gains, their deduction for losses also should be deferred.

Under current law, deferring gains is easy for many taxpayers.⁸⁹ Gains are not taxed until realization – a step that taxpayers can choose to delay. If they die holding the investment, their gain will *never* be subject to the income tax because, under current law, heirs take property with a fair market value basis.⁹⁰ Empirical studies suggest that this rule spares as much as 80% of capital gain from income tax.⁹¹

⁸⁹ This analysis obviously does not hold – and so loss limitations are less important – for property that is marked to market under current law, including dealer and electing trader positions under Section 475 and 1256 contracts. Likewise, the analysis does not hold when an interest charge is added to tax on gains, as is the case with PFICS. See Section 1291. Income is also accelerated on debt securities, although possibilities for strategic trading remain. See generally Jeff Strnad, *The Taxation of Bonds: The Tax Trading Dimension*, 81 Va. L. Rev. 47 (1995) (showing that strategic trading can still be a serious problem for debt). An analysis of debt securities generally is beyond this Article's scope.

⁹⁰ See Code Sec. 1014. The long-run status of the basis step-up is unclear. See *supra* note 18

⁹¹ Johnson, *supra* note 3, at 726.

In theory, delaying recognition of gain comes at a cost: taxpayers must remain exposed to the investment's economic return. In practice, however, wealthy taxpayers can hedge most of this economic exposure without triggering tax. They can simulate the economics of a sale – transferring economic return and receiving cash proceeds – while deferring their tax. In 1997, Congress targeted perfect hedges such as short sales against the box with the constructive sale rule of Section 1259. Under this rule, taxpayers who transfer “substantially all” of their opportunity for gain and risk of loss are treated as selling appreciated property. Yet taxpayers can still defer tax while transferring most, but not all, of their economic exposure. For example, assume a taxpayer owns XYZ stock that is worth \$100 and has a zero basis. If he keeps opportunity for gain between \$100 and \$120, practitioners generally agree that his tax is deferred. As I have written elsewhere, these hedging transactions are relatively easy for sophisticated taxpayers.⁹² Since gains can be deferred even when taxpayers make significant changes in their economic return, losses also should be deferred even if taxpayers make correspondingly significant changes.

2. *The Effectiveness Goal*

In seeking to defer losses, policymakers need to beware of an important pitfall. The goal has to be *actually stopping* loss harvesting, and not merely making this practice modestly harder. Put another way, the success of loss limitations depends on whether taxpayers plan around them. To see this point, assume that the wash sale regime is triggered if taxpayers acquire a replacement position that *perfectly* replicates the loss position, but not if the replacement position *approximately* replicates it. This rule works if taxpayers actually are deterred from harvesting losses (e.g., because taxpayers resist

⁹² See generally Schizer, *supra* note 7.

even small changes in economic return). In contrast, the picture is bleaker if all taxpayers respond to the rule – not by giving up on loss harvesting – but by harvesting in a more sophisticated way (e.g., by accepting small economic changes). In this case, loss harvesting continues unabated, but social waste *actually increases* as taxpayers face higher costs, such as economic changes they do not want.

Obviously, in most cases the results are not this clear cut. Some taxpayers give up on planning (the “marginal” ones), while others press on with more costly strategies (the “inframarginal” taxpayers). The key question is whether efficiency gains from marginal taxpayers outweigh efficiency costs from inframarginal taxpayers. To be successful, the rule needs to raise the costs of loss harvesting to the point where this balance becomes favorable (and, ideally, as favorable as possible).⁹³

To sum up, then, the parity goal suggests that, if it is easy to defer gains, losses need to be deferred. The effectiveness goal adds that, if the goal is to defer losses, the system needs to do it effectively. There is no point in simply making loss harvesting a bit more difficult; the wash sale regime actually has to *stop* the practice in enough cases.

B. The “Call Spread” Theory: A Guide for Policymakers

What does this mean for the wash sale rules? Before turning to possible statutory language or concrete applications, the first step is to begin at the conceptual level. If losses need to be deferred as much as gains, one approach is to coordinate the standard for wash sales with the standard for constructive sales. These regimes define, in the case of a constructive sale, how much a taxpayer’s economic exposure *can* change while still deferring gains and, in the case of a wash sale, how much it *must* change in order to accelerate losses. If Section 1259 makes it easy to defer tax on gains, Section 1091

⁹³ See generally the sources cited in note 25, *supra*.

should make it correspondingly difficult to accelerate deductions for losses. Keeping even modest exposure to the depreciated investment should be enough to defer the loss, if this exposure is enough to defer gain. By analogy to Section 1259, then, the condition for avoiding a wash sale should be that the seller of a loss position has to eliminate substantially all risk of loss and opportunity for gain in the loss position for a minimum period of time.

As noted above, practitioners generally believe that a taxpayer who keeps opportunity for gain between 100% and 120% of an investment's fair market value in a three-year hedging transaction (i.e., a 100–120 call spread) has not substantially eliminated risk of loss and opportunity for gain.⁹⁴ Just as this level of economic exposure is enough to defer gain (i.e., by avoiding Section 1259), so too should it be enough to defer loss (i.e., by *triggering* Section 1091). A wash sale regime should be triggered if, during the window period, the seller of a loss position enters into a 100–120 call spread or some other economic position offering at least as much economic exposure to the loss position. In theory, then, there should be a wash sale for any replacement position with a “delta” as high as that of a 100-120 call spread.⁹⁵ This is a very broad test. For example, it covers most principal-protected exchangeable securities and call options.

Of course, a test based on delta is too sophisticated a concept for many taxpayers to apply, while “offering as much exposure as a 100-120 call spread” is too mushy to be a legal standard. Thus, neither approach is proposed here as the operative doctrine. The

⁹⁴ See generally David M. Schizer, Hedging Under Section 1259, 80 Tax Notes 345 (1998); see also Rev. Rul. 03-7, IRB 2003-5, 363 (Feb. 3, 2003) (finding no constructive sale on variable delivery forward contract that exposes seller to first 25% of appreciation plus 20% of appreciation thereafter).

⁹⁵ “Delta” is the change in price in one position (e.g., the call spread) when the other position (e.g., the loss position) declines in value by one dollar. For example, assume that a call option appreciates by 20 cents when the underlying stock appreciates by a dollar. This is a delta of .2. See Hull, *supra* note 5, at 298-307.

goal here is not to formulate statutory language, but to determine the right answer as a matter of policy.

C. Four Doctrinal Applications

What are the “call spread” theory’s practical implications? Most straightforwardly, it justifies an unpopular aspect of current law. In addition, the theory supports various changes in Section 1091. Some would be easy to administer, while others would be more difficult. The goal in this Section is not to offer definitive recommendations, but to survey a menu of possibilities for policymakers to consider.

1. Current Law for Options

Under the “call spread” theory, the regime should indeed be triggered when taxpayers replace depreciated stock with call options that have a high enough delta. To be precise, the option has to have a delta as large as that of a 100% – 120% call spread. As an administrability compromise, though, it is plausible to dispense with the delta test, finding a wash sale whenever a call option is purchased in the window period. This is indeed the rule under current law.⁹⁶ Commentators often criticize this result as overbroad since the option offers a different economic return than the stock,⁹⁷ but the analysis here shows that current law is appropriate. A contribution of this paper, then, is to offer a theoretical rationale for this unpopular rule.

This is not to say that the treatment of options under current law already conforms perfectly to the “call spread” theory. Two straightforward changes are needed. First, just as there is a wash sale if an option replaces stock, so too should there be a wash sale if the

⁹⁶ See Code Sec. 1091(a).

⁹⁷ See, e.g., Nijenhuis, *supra* note 9.

reverse happens – that is, if stock replaces an option.⁹⁸ The stock replaces not just a *fraction* of the economic return on the option, but *all* of it (while obviously adding more).

Second, a wash sale needs to be triggered when a taxpayer replaces a short position with a put option (i.e., even though the put does not perfectly replicate the short sale).⁹⁹ Current law arguably does not provide this result. Section 1091(e) would apply if “substantially identical stock or securities were sold,” but here a security (the put) was *purchased*, not sold.¹⁰⁰ Alternatively, Section 1091(e) would be triggered if “another short sale . . . was entered into,” but a put is formally different from a short sale. There are also economic differences, especially if the put is not deep in the money.¹⁰¹ Guidance is needed here to clarify that a wash sale is indeed triggered.

2. *Positions in Substantially Similar or Related Property*

In addition to justifying the current rule for options, the “call spread” theory also suggests that, in general, a broad test is needed to match loss and replacement positions. For example, each of the following transactions should be wash sales under this theory, but may not qualify under current law: replacing a mutual fund with a single-premium variable life insurance contract in which the death benefit is based on the same fund (or a so-called “clone” fund); replacing stock with a so-called “DECS,” i.e., a security issued by a third party that offers most, but not all, of the stock’s economic return; and replacing stock with a call option to buy the variable life insurance or DECS.

⁹⁸ Under current law, the stock does not trigger a wash sale unless it is substantially identical to the option. See *supra* note 63.

⁹⁹ If the stock appreciates, the loss on the short sale is unlimited, while the loss on the put is capped at the premium.

¹⁰⁰ Nor is the put substantially identical to the underlying stock, given the economic differences between the two.

¹⁰¹ In response, the government might invoke Section 1233(b). For a discussion of this issue, see *supra* note 53.

There are two ways to cover these (and similar) transactions. First, under current law, there would be a wash sale if the replacement position qualified as a “contract” or “option.” A broad construction of these phrases could conceivably reach these replacement positions, although it is a particular stretch for the insurance contract. To eliminate the need for this creative reinterpretation, policymakers should consider a statutory amendment that substitutes the word “position” for “contract” and “option.” As defined in the straddle rules, this broader term means “an interest (including a futures or forward contract or option).”¹⁰² The phrase should be broad enough to cover the insurance contract and optionally-exchangeable securities (and, for that matter, periodic swaps).¹⁰³

A second step, which can either supplement or replace the one described above, is to jettison the requirement that replacement and loss positions have to be “substantially identical.” Old authorities construing this language allow taxpayers to avoid a wash sale based on very modest disparities in credit risk,¹⁰⁴ economic yield,¹⁰⁵ term to maturity,¹⁰⁶

¹⁰² See Code Sec. 1092(d)(2); see also Code Sec. 246(c)(4)(C) (tolling holding period for dividends-received-deduction if “a taxpayer has diminished his risk of loss of holding 1 more other positions”).

¹⁰³ The arguable omission of periodic swaps is a perfect end run, discussed above. See *supra* Part III.A. Further guidance is needed to clarify how similar the position and underlying property need to be; at a minimum, there needs to be a positive correlation in their values. Thus, replacing a long with a short should not trigger a wash sale. Cf. *supra* Part III.H. The concept could be further narrowed with the notion of “constructive similarity” described below. See *infra* Part IV.C.3.

¹⁰⁴ See *supra* Part III.E.

¹⁰⁵ See, e.g., Rev. Rul. 60-195, 1960-1 CB 300 (otherwise identical Turnpike Authority bonds were held not to be substantially identical because one paid 3.45% interest, while the other paid 4.5% interest); Rev. Rul. 76-346, 1976-2 CB 247 (difference in yield (6.375% vs. 4.25%) is enough to render bonds not substantially identical when coupled with a difference in maturity dates of approximately ten year, and the fact that one is redeemable to pay estate taxes and the other is not); Priv. Rul. 6906200550A (June 20, 1969) (bonds are not substantially identical where bonds that are sold have interest rates of 4.25% and 4.125%, and bonds that are purchased have interest rate of 4%, and maturity and call dates are different); Priv. Rul. 5512154870A (Dec. 15, 1955) (otherwise identical bonds are not substantially identical because of difference in yield (3.8% vs. 4.15%)).

¹⁰⁶ See, e.g., *Hanlin*, CA-3, 39-2 USTC 9783, 108 F.2d 429 (1939), *aff’d* 38 BTA 811 (1938) (ignoring very modest differences in maturity); Priv. Rul. 6512236170A (Dec. 23, 1965) (finding no wash sale when taxpayer replaced bonds due on April 1997 and Oct. 2001 and paying interest of 1 ½% to 5 ½% with bonds due Nov. 1999 and paying interest of 1 ¾% to 5 ½%).

and seniority.¹⁰⁷ Under these authorities, the insurance contract probably isn't substantially identical to the stock,¹⁰⁸ and the DECS may not be either.¹⁰⁹ An alternative is the "substantially similar or related property" ("SSRP") test of Section 246.¹¹⁰ This change would ensure that a wash sale is triggered, for instance, when stock is replaced with a call option to purchase a DECS or when one indexed mutual fund is replaced with another.¹¹¹

3. *Constructively Similar Positions*

Thus far, the proposed reforms are relatively simple. However, they also are broader than the "call spread" theory requires. For instance, if an out-of-the money call option has a lower delta than a 100 – 120 call spread, the parity goal doesn't require a wash sale. Can the requisite economic relationship be specified more precisely? The answer is "yes," but the standard becomes more complex and harder to administer.

For instance, the 1091 standard can be tied explicitly to Section 1259. To avoid a wash sale, the seller of a loss position would be required, by analogy to Section 1259, to eliminate substantially all the risk of loss and opportunity for gain in the loss position for a minimum period of time. Or, put another way, a wash sale would be triggered if a taxpayer acquires a position that is "constructively similar" to the loss position during the

¹⁰⁷ See, e.g., Reg. § 1.1233-1(d)(1) (preferred stock of a corporation generally is not considered substantially identical to common stock of the same corporation).

¹⁰⁸ In addition, an alternative argument for avoiding a wash sale is that the insurance contract is not a "security." For a discussion of various definitions of the term, see *supra* note 37.

¹⁰⁹ The DECS is issued by a third party, and there is (old) authority suggesting that differences in credit are enough to avoid a wash sale. See generally Part III.E., *supra*. There may also be an argument that differences in economic return render the DECS and stock not substantially identical, although the answer here probably depends upon one's reading of a ruling about convertible preferred stock. See Rev. Rul. 77-201, 1977-1 CB 250 (finding that convertible preferred stock is substantially identical to the underlying common both because the two trade in tandem and because the former is an option within the meaning of Section 1091(a)).

¹¹⁰ Section 246 denies corporate taxpayers the dividends-received deduction in some circumstances if they hedge their portfolio stock. In defining hedging broadly, Congress presumably felt that the "substantially identical" test was not broad enough, so they supplemented it with the SSRP standard.

¹¹¹ For a discussion of this problem, see *supra* text accompanying notes 77 and 78.

window period. Under this approach, the basic question is whether the taxpayer is retaining enough exposure (i.e., through the replacement position) to avoid a constructive sale (i.e., assuming, hypothetically, that the taxpayer had hedged instead). If a replacement position gives the taxpayer enough exposure to *avoid* a constructive sale, then it would *trigger* a wash sale.

A challenge with this doctrinal formulation is that it compares apples and oranges. In one case, the taxpayer keeps a position and hedges it, and in the other she sells the position and replaces it. How can these two circumstances be meaningfully compared? To do so, the seller of a loss position will have to compare the replacement position to a hypothetical transaction, which is assumed to have three properties. First, instead of selling the loss position, the taxpayer is assumed to hedge it. Second, the loss position is assumed to be appreciated (i.e., so that Section 1259 can apply). Third, the hedge is assumed to leave the taxpayer with as much retained exposure as is offered in the replacement position – that is, the position that the taxpayer has, in fact, acquired. In other words, the replacement position is assumed to represent the net return of the loss position combined with the hypothetical hedge. The question, then, is whether this residual economic return would be great enough to avoid a constructive sale. If so, this exposure would be large enough to trigger a wash sale.

As an example of this (admittedly cumbersome) inquiry, assume that a taxpayer sells stock worth \$100 at a loss and purchases a call option with an exercise price of \$100. To see whether this replacement position is “constructively similar” to the loss position, the taxpayer must analyze a hypothetical hedging transaction. This hypothetical hedge must net the same economic return (i.e., when combined with the stock) as the at-

the-money call option that the taxpayer actually purchased as a replacement position. In this case, buying an at-the-money put option (and borrowing against the locked-in value) does the trick (i.e., since the net return on stock, a \$100 put option, and a borrowing, is equivalent to that of a \$100 call option). Since the purchase of an at-the-money put option *does not* trigger a constructive sale, the acquisition of an at-the-money call option *would* trigger a wash sale under the “constructive similarity” approach.

Needless to say, there are administrability hurdles here. For example, what if the price of the loss position has changed by the time the taxpayer acquires the replacement position? In comparing the economic return on the loss position with the economic return on the replacement position, do we value the underlying as of the date when it is sold? Or later when the replacement position is acquired?¹¹² Even more fundamentally, this approach to Section 1091 requires us to apply our understanding of Section 1259 – but, unfortunately, Section 1259 is itself ambiguous on many key fronts.¹¹³

Although the administrability problems here are serious, there are two reasons why they should become easier over time. First, gaps in Section 1259 ultimately will be filled as courts decide cases and the government issues regulations and rulings. Second, tying these two standards together may help keep the government and taxpayers honest. If they make aggressive arguments about one of these standards, it could backfire on them for the other. For instance, if taxpayers succeed in narrowing Section 1259, they would inadvertently expand Section 1091. Likewise, if the government aggressively

¹¹² For example, assume that the taxpayer sells stock for \$80 and the stock price immediately increases to \$100, at which point the taxpayer buys a \$100-120 call spread. In deciding whether this call spread is “constructively similar,” what value do we use for the loss position? A value of \$100 means there clearly is a wash sale, while a value of \$80 offers an argument that there is not (i.e., because the call spread is out-of-the money). Either rule is plausible, though the use of the sale price (i.e., \$80) has the advantage of giving the taxpayer credit for the full economic exposure he bore before acquiring the replacement position.

¹¹³ For a discussion of ambiguities in Section 1259, see Schizer, *supra* note 31.

broadens the definition of a constructive sale, the effect would be to constrict the wash sale regime.

4. *Baskets*

Whether or not this “constructive similarity” approach is adopted, a more effective approach is needed for finding wash sales when a position based on a basket of stocks (such as a mutual fund or fund derivative) replaces either a single stock or another basket. For example, what if the taxpayer sells XYZ and buys a derivative based on a portfolio of stocks that *includes* XYZ? Or what if the taxpayer sells one mutual fund that includes twenty stocks, and buys a new mutual fund that includes some of these stocks (or all of them, but with a different weighting than the old fund)?

Under current law, taxpayers make aggressive arguments about these situations. There certainly are economic differences between the loss and replacement positions, at least when they are viewed as a whole, so they are unlikely to be “substantially identical.” Of course, the government may seek to bifurcate the positions, finding a wash sale to the extent that components of the loss and replacement positions match each other. Yet bifurcation is not clearly authorized under Section 1091. In response, policymakers should require bifurcation when it is administratively feasible. As under the 246 regulations, bifurcation should be the rule when fewer than twenty stocks are involved.¹¹⁴

Like in the 246 regulations, the focus for larger baskets should be on the degree of overlap between the two positions. A caveat, though, is that the 246 regulations are too generous in finding that baskets with less than 70% overlap are not “substantially similar

¹¹⁴ See Reg. § 1.246-5(c)(1)(v).

or related.”¹¹⁵ Since portfolios with 69% overlap still track each other closely, taxpayers game this test. Instead, a much smaller overlap (e.g., 20% to 40%) should trigger a wash sale, consistent with the “call spread” theory. For instance, when one actively managed mutual fund replaces another, there should be a wash sale if both focus on the same sector.

Admittedly, a problem with an overlap test is that portfolios can track each other without any overlap. For instance, one portfolio can have GM, Dell, and ExxonMobil, while the other can have Ford, Gateway, and Texaco. As the portfolio grows, firm-specific risk becomes less important, while each portfolio reflects the same industry and market risks.¹¹⁶ In response, a backup rule should compare the expected return on the two portfolios. By analogy, the Section 246 regulations have an anti-abuse rule that applies when positions (1) are “reasonably expected to virtually track” each other and (2) are part of a tax motivated plan.¹¹⁷ By giving clear guidance about when this sort of rule applies, the government can give it teeth. One approach is to ask whether the positions are sold or marketed as substitutes for each other. Another (quite broad) approach could draw on the straddle rules: If one portfolio is compared with a short position in the other (e.g., a short forward contract), would the two be a straddle? If so, the anti-abuse rule would apply.¹¹⁸

Even so, there is at least one reason why loss deferral is less important when one mutual fund replaces another: Because fund managers focus on pretax performance,

¹¹⁵ See Reg. § 1.246-5(c)(1)(iii).

¹¹⁶ This strategy was used successfully in *Duke Energy Corp v. United States*, 49 F. Supp. 2d. 837 (W.D.N.C. 1999) (finding that two portfolios are not substantially similar).

¹¹⁷ See Reg. § 1.246-5(c)(1)(vi).

¹¹⁸ I am indebted to Peter Canellos for this idea.

funds are likely to throw off current gain.¹¹⁹ Since the timing of gains is accelerated, at least to an extent, the deferral of losses becomes less important.

D. Caveat: Economic Exposure Sometimes is an Ineffective Friction

So far, this Part has argued for more aggressive loss deferral, and has identified ways of pursuing this goal with the wash sale rules. Yet this regime has a limitation: Taxpayers can always accelerate their deduction if they are willing to make a significant enough change in their economic return. The concern, then, is that even the strengthened version of Section 1091 advocated here is not strong enough to be effective in all situations. This “effectiveness” concern may be especially serious for diversified taxpayers, since firm-specific risk (and, correspondingly, the omission of a particular firm from their portfolio during the window period) is less likely to be important. Indeed, the very fact that the loss position has declined in value suggests that it has become a less salient part of the taxpayer’s portfolio.

Of course, the point should not be overstated. Even under current law, the wash sale rules discourage some taxpayers from harvesting losses (e.g., those who do not have access to the perfect end runs described above). By strengthening the regime, the reforms proposed here will discourage still more loss harvesting. For instance, a taxpayer who sells a high-tech mutual fund will have to buy something completely different (e.g., Treasuries or an energy fund). Likewise, a taxpayer with GM will have to replace it with Ford; yet because the firms are competitors, there is a risk that their prices will move in *opposite* directions. For many taxpayers, this is too high a price to pay. Although some residual harvesting will surely remain, the reforms proposed here are still advisable as long as the efficiency gains from marginal taxpayers who are deterred outweigh the

¹¹⁹ See Schizer, *supra* note 7, at 1343.

efficiency losses from inframarginal taxpayers who continue to plan in a more elaborate way. My sense is that this balance is likely to be favorable. Even so, there may be alternatives that strike an even more favorable balance. While alternatives generally are beyond this Article's scope, a brief look at two is worthwhile.

1. Broader Capital Loss Limitation

On "effectiveness" grounds, the capital loss limitations have an important potential advantage. Unlike the wash sale rules, they do not tie the tax benefit to economic exposure. To deduct the loss, taxpayers must recognize taxable gain. They cannot change this immutable fact by shying away from their loss position after selling it. Altering their economic position does not help. Put another way, economic exposure does not serve as a (potentially inadequate) friction in this regime, as it does in Section 1091.

How can reformers build on this advantage? The main challenge is to shore up the capital loss limitation's other weaknesses, some of which were mentioned briefly above. For example, as Robert Scarborough has suggested, the definition of capital gain can be further refined (e.g., to exclude time value returns).¹²⁰ In addition, losses can be deferred to a greater degree. For instance, instead of matching a dollar of recognized losses with the *first* dollar of recognized gain, the loss could be matched with the *last* dollar of gain; as under the straddle rules, losses could be deferred to the extent of *unrecognized* gain.¹²¹ Needless to say, these modifications pose difficult administrability and political issues, but these are beyond this Article's scope.

¹²⁰ See generally Scarborough, *supra* note 3.

¹²¹ I thank Alvin Warren for this observation. As an illustration, assume that a taxpayer has \$100 of realized losses. He also has two appreciated stocks. Stock A has a \$40 basis and a \$140 fair market value, while Stock B has a \$30 basis and a \$330 fair market value. Under current law, the taxpayer can deduct his

2. Accelerating Tax on Gain

Instead of deferring losses, policymakers can also curtail the timing option by accelerating gains. Indeed, under a mark-to-market system, there would be no need to defer losses at all. Likewise, even if a realization system is retained, the wash sale regime could be more lenient if the constructive sale regime were tougher. In theory, a constructive sale could be triggered – not just when the taxpayer transfers substantially all of her economic return – but when she transfers a relatively modest amount.¹²² If this were the test for gains, the wash sale regime would not need to be as broad.¹²³

In theory, the “effectiveness” concern could also arise for a tough constructive sale regime, since taxpayers can avoid this regime by holding the appreciated investment unhedged. Yet effectiveness should be less of a problem here than with a tough wash sale regime. The reason is that a taxpayer with highly appreciated stock is *less likely to be diversified*. The appreciated stock probably has outperformed the rest of the taxpayer’s portfolio, becoming a disproportionately large part of it. As a result, holding appreciated stock unhedged is an uncomfortable way to avoid a constructive sale. In contrast, a depreciated position is unlikely to loom as large within the taxpayer’s portfolio, as discussed above, so omitting it from the portfolio (i.e., to avoid the wash sale regime) should not be as unappealing. To sum up, a tough constructive sale regime has at

loss by selling Stock A. Under this straddle-type proposal, the taxpayer has to sell *both* Stocks A and B (i.e., to ensure that he does not have \$100 of unrecognized gain anywhere in his portfolio).

¹²² Under a straddle-type standard, for instance, taxpayers would have a constructive sale whenever they “substantially diminished” their risk of loss – that is, essentially whenever they hedged. See Section 1092. For a proposal to use a straddle-type standard for constructive sales, see Schizer, *supra* note 7.

¹²³ Although it would be less necessary to defer losses, the wash sale regime would still come under some pressure if the constructive sale regime were toughened. The reason is that taxpayers would have more taxable gains, and thus would have greater use for deductible losses. I am indebted to Dana Trier for this observation.

least one advantage over a tough wash sale regime. Other issues also bear on this comparison, but lie beyond this Article's scope.¹²⁴

V. Conclusion

The wash sale rules are too porous. Sophisticated taxpayers are deducting losses without changing their economic position at all. In response, the government should clarify that these perfect end runs are unavailable. At a minimum, taxpayers should not be allowed to deduct losses if they have made essentially no change in their economic position.

This Article also makes a more controversial claim: Because it is so easy to defer gains, even when taxpayers make significant changes in their economic exposure, it must be correspondingly difficult to accelerate losses. In theory, loss should be deferred whenever taxpayers acquire a replacement position with a delta as great as a 100 – 120 call spread. This theory justifies an aspect of current law that has been widely criticized: in fact, replacing stock with a call option *should* trigger a wash sale. In this spirit, a number of other reforms are also proposed, including the need for a wash sale when a put option replaces a short sale, when equity-linked life insurance replaces the underlying equity, and when one sector-specific mutual fund replaces another. Needless to say, these various reforms are not perfect, and it is worth looking for better alternatives. Yet in the absence of fundamental reform, narrow incremental remedies are all we have. We need to do the best we can with them.

¹²⁴ For example, the constructive sale and wash sale rules share a common administrability challenge: they have to treat formally distinct transactions as, in effect, a single transaction. A constructive sale must treat the appreciated position and hedge as, in effect, a sale, and a wash sale has to treat the loss position and replacement position as, in effect, a nonsale. The administrability burdens are less severe if these anti-abuse rules are narrow in scope, and thus are triggered only if the two formally separate positions are perfect economic matches. Yet because narrow rules are easy to avoid, at least one of these regimes has to be quite broad. So we need to link pairs of transactions that are not perfect matches – indeed, far from it. Either way, there will be significant administrative costs.