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Report No. 1456
January 14, 2022

The Honorable Richard E. Neal
Chairman of Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington DC 20515

Re: *Report No. 1456 – Comments on Wash Sale Provisions of the House Proposals for the Build Back Better Act*

Dear Mr. Neal:

I am pleased to submit comments on proposed amendments to the wash sale rules in Section 1091 of the Internal Revenue Code of 1986, as amended, contained in the budget reconciliation legislation known as the "Build Back Better Act" passed by the House of Representatives on November 19, 2021 pursuant to instructions in S. Con. Res. 14, the Concurrent Budget Resolution for FY2022 (the "**Proposed Wash Sale Rules**"). Substantively identical proposed wash sale rules were introduced in the Senate by Senator Ron Wyden on December 11, 2021. Because the Senate may vote on the legislation, we have limited our comments in this Report to certain critical aspects of the Proposed Wash Sale Rules that we believe should be modified in any version that is enacted into law.

Respectfully submitted,

Gordon E. Warnke
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Report No. 1456

New York State Bar Association Tax Section
Comments on Wash Sale Provisions of the House Proposals
for the Build Back Better Act

January 14, 2022

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I. Introduction

This Report¹ provides comments on proposed amendments to the wash sale rules in Section 1091 of the Internal Revenue Code of 1986, as amended (the “**Code**”), contained in the budget reconciliation legislation known as the “Build Back Better Act” passed by the House of Representatives on November 19, 2021 pursuant to instructions in S. Con. Res. 14, the Concurrent Budget Resolution for FY2022 (the “**Proposed Wash Sale Rules**”).² Substantively identical proposed wash sale rules were introduced in the Senate by Senator Ron Wyden on December 11, 2021. Because the Senate may vote on the legislation, we have limited our comments in this Report to certain critical aspects of the Proposed Wash Sale Rules that we believe should be modified in any version that is enacted into law.

Part II of this Report discusses the Proposed Wash Sale Rules. Part III contains an explanation of our recommendations.

II. House Proposal Expanding Wash Sale Rules to “Specified Assets” and Adding Related Party Rule

Section 1091(a) disallows any deduction from the sale or other disposition of shares of stock or securities where the taxpayer has acquired, or has entered into a contract or option to acquire, substantially identical stock or securities within the period beginning 30 days before the sale and ending 30 days after the sale (the “**the wash sale period**”).³ For purposes of Section 1091, the term “stock or securities” includes contracts or options to acquire or sell stock or securities. There is an exception to this rule for dealers in stock or securities in the case of losses sustained in a transaction made in the ordinary course of such business.⁴ In addition, Section 1091(d) defers the otherwise disallowed loss through a basis adjustment: the basis of the stock or securities the acquisition of which caused the wash sale is adjusted to include the barred loss. This mechanism has the effect of deferring the taxpayer’s loss, allowing the taxpayer to recognize it when the acquired stock or securities are later sold.⁵

¹ The principal drafter of this Report was Lucy Farr, with substantial assistance from Danielle Rapaccioli and Alanna Phillips. Comments were received from Jennifer Alexander, Daniel Altman, Tyler Arbogast, John Barrie, Kimberly Blanchard, Bora Bozkurt, James Brown, Robert Cassanos, Peter Connors, Martin Hamilton, Joshua Holmes, Robert Kantowitz, Jiyeon Lee-Lim, John Lutz, Yaron Reich, Eschi Rahimi-Laridjani, Peter Ritter, Michael Schler, Stephen Shay, Michael Shulman, Eric Sloan, Andrew Solomon, Philip Wagman, and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or House of Delegates of the New York State Bar Association. References to “we”, “us” or “our” in this Report refer to the Executive Committee of the Tax Section of the New York State Bar Association.

² S.Con.Res.14, 117th Cong. (2021-2022).

³ I.R.C. § 1091(a).

⁴ *Id.*

⁵ I.R.C. § 1091(d).

The Proposed Wash Sale Rules (and the substantively identical rules introduced in the Senate by Senator Wyden) make four significant changes to the current wash sale rules.⁶ First, the Proposed Wash Sale Rules expand the types of assets subject to the wash sale rules beyond stocks and securities to a list of “specified assets.”⁷ Specified assets is defined to include foreign currency, commodities, and “[e]xcept as provided by the Secretary, any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary,” as well as any contracts or options to acquire or sell or notional principal contracts with respect to each of them.⁸

Second, the Proposed Wash Sale Rules provide that, if a taxpayer “*or a related party*” acquires substantially identical specified assets within the wash sale period, a loss will be disallowed (the “**Related Party Rule**”).⁹ Related party is defined to include, among others, the taxpayer’s spouse; any dependent of the taxpayer; any individual, corporation, partnership, trust, or estate which controls, or is controlled by (within the meaning of Section 954(d)(3)), the taxpayer, the taxpayer’s spouse or dependent; and, to the extent provided by the Secretary in regulations or other guidance, any individual who bears a relationship to the taxpayer described in Section 267(b) if such taxpayer is an individual.¹⁰

Third, the Proposed Wash Sale Rules contain a modified basis adjustment rule (the “**Basis Adjustment Rule**”) that would de-link the basis adjustment from the specified assets that caused the wash sale. The new rule would provide that, if the taxpayer (or the taxpayer’s spouse, but not another related party) acquires substantially identical specified assets during the period beginning 30 days before the disposition that caused the wash sale and ending with the close of the taxpayer’s first taxable year that begins after such disposition (the “**Repurchase Period**”), the basis of the newly acquired specified assets will be increased by the amount of the disallowed loss.¹¹ As suggested by the legislative language, the purpose of this change is to prevent the transfer of basis from the taxpayer to a related party (other than the taxpayer’s spouse) that would otherwise result if the current-law basis adjustment rule were to apply in the context of a related party wash sale.

Finally, the Proposed Wash Sale Rules add a business needs exception that exempts sales or other dispositions of foreign currency and commodities that are directly related to the business needs of a trade or business of the taxpayer or that are part of a hedging transaction (the “**Business Needs Exception**”).¹² However, the Business Needs Exception does not apply to

⁶ The Proposed Wash Sale Rules also make other changes that we do not consider critical for consideration prior to the enactment of the statute and that therefore are not discussed in this Report.

⁷ H. COMM. ON RULES, 117TH CONG., RULES COMM. PRINT 117-18: TEXT OF H.R. 5376, BUILD BACK BETTER ACT § 138152(d) (Comm. Print 2021).

⁸ *Id.* at § 138152(h).

⁹ *Id.* at § 138152(a) (emphasis added).

¹⁰ *Id.* at § 138152(g). Certain 2014 legislative proposals contained a similar related-party wash sale proposal. We commented on that proposal in a previous report. *See* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT NO. 1318, REPORT ON THE HOUSE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF FINANCIAL INSTRUMENTS AND CORRESPONDING PROPOSALS BY THE OBAMA ADMINISTRATION 79 (Mar. 6, 2015) (hereinafter Report No. 1318).

¹¹ *Id.* at § 138152(d).

¹² *Id.* at § 138152(i).

transactions that are directly related to the trade or business of trading foreign currencies or commodities.

III. Recommendations Regarding the Proposed Wash Sale Rules

A. Modifications to the Provisions Affecting Related Party Wash Sales

1. The Basis Adjustment Rule

We recommend that the Basis Adjustment Rule be modified to make the consequences of a related party wash sale be more consistent with those that arise from a single taxpayer wash sale and with the tax policy that drove the enactment of Section 1091. This can be achieved by applying a loss deferral mechanism similar to that of Section 267(f),¹³ which defers, rather than denies, a loss until the property is transferred outside of a controlled group.

The Basis Adjustment Rule has two serious flaws. First, it appears that the drafters of the Proposed Wash Sale Rules likely intended the Basis Adjustment Rule to apply only when the wash sale is caused by a purchase by the taxpayer or the taxpayer's spouse, and to deny any basis increase when the wash sale is caused by a purchase by a related party (other than the taxpayer's spouse). In other words, the drafters may have intended for a permanent disallowance of the loss to the taxpayer and its related party, viewed together. We believe that such a result, if intended, would be unduly harsh and contrary to rational tax policy.

Second, the Basis Adjustment Rule, as drafted, allows a taxpayer to recognize losses even though the taxpayer's related party continues to hold substantially identical specified assets. Under both current law and the Proposed Wash Sale Rules, in the case of a single taxpayer wash sale, the taxpayer's disallowed loss may only be recognized when the taxpayer *disposes of* substantially identical assets (generally, the assets that caused the disallowance in the first place). This makes sense as a policy matter; the taxpayer must have a genuine reduction in its economic exposure to the relevant asset in order to free up the loss in question. By contrast, in the case of a wash sale created by a purchase by a related party under the Proposed Wash Sale Rules, the Basis Adjustment Rule, read literally, permits the taxpayer to recognize its loss by acquiring substantially identical specified assets and then disposing of them, with no minimum holding period, all while the taxpayer's related party continues to hold the specified asset that caused the wash sale in the first place.¹⁴ As a result, the Basis Adjustment Rule incentivizes taxpayers to engage in transactions with little or no economic substance in order to free up losses in a manner that would not be possible if only a single taxpayer were involved.

Example 1. On November 15, 2022, Party A sells specified asset X with a basis of \$100 for \$50, its fair market value. On November 16, 2022, Party B, a related

¹³ I.R.C. § 267(f)(2).

¹⁴ Although the Basis Adjustment Rule does not by its terms distinguish between single taxpayer wash sales and related party wash sales, it operates differently on the two transactions as a practical matter. In the case of a single taxpayer wash sale, the basis increase will generally apply to the asset acquired by the taxpayer that gave rise to the wash sale in the first place. While the taxpayer can dispose of that asset at any time to free up the loss, it would thereby reduce its economic exposure to that asset. In the related party situation, the related party can hold the asset that caused the wash sale for an indefinite period—maintaining the economic exposure to the asset sought by the taxpayer and its related party—while the taxpayer frees up its tax loss in the manner described in Example 1.

party, buys specified asset X for \$50 and continues to hold it. On December 20, 2022, Party A buys specified asset X for \$50 and sells it for \$50 later that same day (perhaps immediately after the purchase) claiming a loss of \$50 equal to the originally disallowed loss. The purchase by Party B creates a wash sale under the Proposed Wash Sale Rules, disallowing Party A's loss and not requiring a basis adjustment to related Party B's interest in specified asset X. Party A's purchase of specified asset X on December 20, 2022, does not create a wash sale because it occurs more than 30 days after Party A's original disposition; instead, under the Basis Adjustment Rule, Party A's basis in specified asset X that is acquired on December 20, 2022 is increased by the amount of the loss disallowed in the wash sale (i.e., from \$50 to \$100). Thus, Party A is able to take the loss on specified asset X by increasing its exposure for less than a day (and never eliminating the Party A/B economic exposure), and related Party B maintains its cost basis (of \$50).

Under current Section 1091(a), a taxpayer can avoid the application of the wash sale rules by either eliminating its economic exposure for 30 days after selling the asset, or “doubling up” on economic exposure to the asset for a period of more than 30 days (i.e., by purchasing identical assets more than 30 days before the loss sale). Either way, the taxpayer will have changed its economic exposure to the relevant asset for at least a 30-day period. The operation of the Basis Adjustment Rule in the case of a related party wash sale allows the taxpayer and its related party to take the loss deduction while preserving their collective economic exposure to the relevant asset, other than during a very brief interval during which the taxpayer accomplishes a purchase and quick sale. This would appear to frustrate the purposes of the wash sale rules.¹⁵

While operating in an overly permissive manner for many taxpayers, the Basis Adjustment Rule also operates in an overly restrictive manner for other taxpayers: if the taxpayer misses its window of opportunity during the Repurchase Period to reacquire substantially identical specified assets (or is unable to reacquire such assets for operational or other reasons), it will forever lose its loss. For taxpayers with multiple related entities, such as groups of insurance companies, a wash sale might only be identified at a point at which it may be too late to take steps to prevent the permanent disallowance of the loss. As drafted, therefore, the Basis Adjustment Rule is both insufficiently restrictive in some respects and overly restrictive in others, and as a result fails to support the underlying policy goals of the wash sale rules. Moreover, it would incentivize noneconomic behavior.

In light of these problems with the Basis Adjustment Rule, we recommend the Basis Adjustment Rule be replaced by a loss deferral and trigger mechanism analogous to Section 267(f). Section 267(f)(2) provides that “in the case of any loss from the sale or exchange of property which is between members of the same controlled group . . . such loss shall be deferred until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.”¹⁶ Under such an approach, the taxpayer could take its previously disallowed loss at the time that

¹⁵ Moreover, the Basis Adjustment Rule would not appear to prevent the taxpayer from hedging its exposure to the specified asset during the brief interval in which it holds the asset.

¹⁶ I.R.C. § 267(f)(2).

the related party sells the specified asset that gave rise to the wash sale, as long as there is no reacquisition by the taxpayer or any related party (within the meaning of Section 1091) of a substantially identical specified asset during the 60-day period around the date of the subsequent sale.¹⁷ Such a rule would provide for consequences more consistent with those resulting from a single taxpayer wash sale, because in each case the later sale of the asset causing the wash sale would generally free up the loss. This result would also align with the policy of allowing the taxpayer to recognize its loss when it (and its related party) have genuinely disposed of the relevant asset or have ceased to be related. As is the case for Section 267(f) purposes, the loss could also be triggered if the taxpayer and the party holding the specified asset become unrelated.¹⁸

We recognize that a downside of this proposal is that it requires that the taxpayer know the circumstances of the related party, including when the related party has sold the relevant assets, but the application of the related party aspects of the Proposed Wash Sale Rules already requires at least some level of knowledge of the related party's activities.

We note finally that our recommendations regarding the Basis Adjustment Rule are consistent with those we made in 2015 in Report No. 1318 when commenting on proposed legislation with similar language.

2. Definition of "Related Party"

We recommend modifying of the definition of "related party" in the Proposed Wash Sale Rules to narrow the circumstances in which entities are treated as related parties to the taxpayer.

The Proposed Wash Sale Rules contain a definition of "related party" that, for the most part, does not rely on other definitions of relatedness found in the Code but rather defines specific relationships that will cause parties to be related. For individuals, the term related party includes the taxpayer's spouse, dependents and individuals with respect to whom the taxpayer is a dependent (each, a "**Related Individual**"). It also includes various categories of retirement and similar tax-deferred plans, such as Archer MSAs and Section 529 plans, as to which the taxpayer or a Related Individual is a beneficiary or has authority to make investment decisions. In this respect, the related party definition appears to be narrowly tailored to reflect the concept of a household unit. We support this narrow approach, as it reflects a practical understanding that a household is a natural economic unit, and in addition that it may be difficult for a taxpayer to obtain information about investment purchases and sales from family members, such as siblings or even parents, outside the immediate household.

However, in addressing entities, the Proposed Wash Sale Rules incorporate by reference other rules that have the effect of broadening the related party definition in a way that is inconsistent with the narrow definition of a Related Individual. Specifically, the Proposed Wash Sale Rules treat as a related party any individual, corporation, partnership or trust that controls, or is

¹⁷ In the case of a short sale under Section 1091(d), the rule should allow the loss when the related party closes out any subsequent short sale (or contract, option, or short notional principal contract in respect of substantially identical specified assets).

¹⁸ The legislation can authorize the Secretary to prescribe rules delineating when the taxpayer and the party holding the specified asset become unrelated.

controlled by, the taxpayer within the meaning of Section 954(d)(3). Section 954(d)(3) defines control to mean direct or indirect ownership of more than 50% of the voting power or value of a corporation, or more than 50% of the beneficial interests in a partnership, trust or estate. For purposes of this rule, Section 954(d)(3) states that rules similar to the rules of Section 958 shall apply.¹⁹

By incorporating the constructive ownership principles of Section 958(b), this rule would have a surprisingly broad reach, with the result that relatively remote entities could be attributed to a taxpayer. Because Section 958(b) references Section 318(a), which has its own concept of related individuals, the purchase of a specified asset by an entity owned by a Section 318(a) related individual could trigger a wash sale even if that individual's direct purchase of the asset would not. For example, an entity owned by the taxpayer's grandparents or parents would be treated as owned by the taxpayer, even if those individuals were not Related Individuals. Such a result makes very little sense, particularly in light of the narrowly tailored definition of a Related Individual as discussed above.

Moreover, depending on how the embedded reference to Section 958 is interpreted, the downward attribution rules of Section 318(a), as modified by Section 958(b), could potentially lead to attribution to partnerships in situations where we believe such attribution was unintended and where it would be inconsistent with the policy underlying the wash sale rules. For example, consider two partnerships, one of which ("**Partnership A**") sells specified assets and the other of which ("**Partnership B**") purchases substantially identical specified assets within the wash sale period. Assume first that a single individual ("**Individual C**") owns more than 50% of the beneficial interests in each of Partnership A and Partnership B. In evaluating whether Partnership A controls Partnership B (or vice versa) and therefore whether the two partnerships are related for purposes of the Proposed Wash Sale Rules, Section 958(b) provides that Section 318(a) shall apply if the effect is to treat a person as a related person within the meaning of Section 954(d)(3). Under the downward attribution rule of Section 318(a)(3)(A), Individual C's interest in Partnership B would be attributed down to Partnership A,²⁰ and therefore Partnership A would control Partnership B within the meaning of Section 954(d)(3) and a wash sale would occur. This result seems consistent with the intent of the Proposed Wash Sale Rules.

On the other hand, if Individual C owns only 1% of Partnership A (but still owns more than 50% of Partnership B), as a policy matter one would not expect the two partnerships to be related for wash sale purposes. However, because there is no ownership threshold for downward attribution to partnerships under Section 318(a)(3)(A), it appears that Individual C's controlling interest in

¹⁹ In addition to the issues discussed in the text, defining control by reference to Section 954(d)(3) creates some uncertainty in importing Section 958 without guidance as to whether and how particular rules of Section 958 – such as Sections 958(a)(2) and 958(b), which are tailored to controlled foreign corporations and contain some provisions specific to foreign persons – should be applied in the context of Section 1091. While we view this issue as less significant than the concerns expressed in the text, if the use of Section 954(d)(3) principles is retained in the final statute we recommend that either the statute or Treasury regulations provide additional clarification on this point.

²⁰ Although Section 958(b) applies by its terms to constructive ownership of stock rather than partnership interests, because Section 954(d)(3) measures control of partnership interests as well as control of interests in stock, the reference in Section 954(d)(3) to "rules similar" to the rules of Section 958 should be read to apply the Section 958 rules regarding constructive ownership of stock to partnership interests that are being tested for control under Section 954(d)(3). In any event, the example above could be modified to replace "Partnership B" with "Corporation B" with the same result.

Partnership B would still be attributed down to Partnership A, making them related under the Proposed Wash Sale Rules. Assuming no other relationships among the parties, this would clearly be an inappropriate result given the lack of economic overlap between the two partnerships. Indeed, such a result appears contrary to the drafters' intent, as evidenced by the fact that the Proposed Wash Sale Rules use the language in Section 954(d)(3) that relates to one party controlling another party (Section 954(d)(3)(A)) but not the language that relates to two parties under common control by one or more persons (Section 954(d)(3)(B)). But for the surprising effect of the downward attribution rule described in this paragraph, the drafters' choice appears designed to avoid treating two widely held vehicles that have overlapping ownership as related parties.²¹ As a result, it would be strange to treat as related two partnerships with only 1% overlapping ownership.

We believe the reference to Section 954(d)(3) should be removed and replaced with a rule that builds on the Related Individual definition and common control of the relevant entity or entities by direct or indirect ownership of more than 50% of their ownership interests by Related Individuals or other entities.²² Under such a rule, two entities would be related to each other if (1) one controlled the other, directly or indirectly, or (2) both were under the common control of either a third entity or the taxpayer and one or more Related Individuals. An individual would be related to an entity if the entity is controlled, directly or indirectly, by the individual and their Related Individuals. Treasury could have authority to issue regulations expanding this definition as necessary to prevent abuse.²³

²¹ There may be circumstances in which two entities with overlapping ownership bases should arguably be considered to be related for this purpose even if no single person or group of Related Individuals owns more than 50% of the entities' ownership interests. For example, two investment funds managed by the same manager, with the same or very similar investor bases, could conceivably engage in transactions that contravene the purposes of the wash sale rules. As a practical matter, however, unless the ownership of the entities overlaps at a very high level (well above 50%), such an arrangement would be difficult to pursue because the investors that do not have matching interests in the two entities would need to be willing to have their investment management decisions be chosen, in part, to benefit the tax results of other investors as opposed to their own pre-tax results. Therefore, such a situation may best be addressed through regulations or an anti-abuse rule as opposed to a statutory rule. An anti-abuse rule could, perhaps, be premised upon a significantly higher standard of overlapping ownership and might take into account how interests in such a fund are marketed to investors. See, for example, similar concepts in Notice 2018-72, 2018-40 IRB 522 (combining two transactions that are priced, marketed or sold in connection with each other for Section 871(m) purposes) and Section 1258(c)(2)(C) (treating transactions marketed or sold to produce capital gain as conversion transactions).

²² As drafted, the related party definition in the Proposed Wash Sale Rules reflects both concepts of economic ownership as well as control. For example, a Section 529 plan is related to an individual if the individual is either a designated beneficiary or controls the plan's investments. Because the wash sale rules reflect policy concerns about a taxpayer purporting to recognize a loss while maintaining economic exposure to the relevant asset, economic ownership would seem to be an important relationship by which to measure relatedness. On the other hand, the wash sale rules can be viewed as a form of anti-abuse rule; from that perspective, they should arguably be limited to parties controlled by the same decisionmaker. Treasury might consider addressing this point in regulatory guidance.

²³ In addition to the "matching funds" possibility discussed at footnote 21 above, situations involving family members that are not Related Individuals may be a logical subject for anti-abuse rules, as contemplated by the provision in the Proposed Wash Sale Rules that authorizes Treasury to expand the related party definition to individuals that are related to each other within the meaning of Section 267(b). RULES COMM. PRINT 117-18, at § 138152(f)(1)(D). While, as discussed above, we support the narrow definition of Related Individuals as a general matter, fact patterns reflecting coordinated purchases and sales by, for example, parents and their adult children could be addressed by an anti-abuse rule.

3. Clarification on the Interaction with Section 267

We recommend that the Proposed Wash Sale Rules be modified to address the interaction between Section 1091 and Section 267. With the expansion of the wash sale rules to apply to transactions involving related parties, certain situations would potentially fall within the scope of both provisions. As a result, clarity is needed to address how Section 1091 and Section 267 are intended to work alongside each other in a rational way.

Section 267 provides that “[n]o deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between” certain related persons.²⁴ Unlike the wash sale rules, Section 267(a) generally results in a permanent denial of the loss, subject to a mitigation rule in Section 267(d) whereby the transferee’s gain on a subsequent disposition of the transferred asset is reduced by the transferor’s previously denied loss. However, for controlled groups of corporations, Section 267(f) defers the loss until either the asset leaves the group or the transferor and transferee are no longer within a controlled group.

Section 267(d)(2) already contains a limited coordination rule, in that the mitigating rule of Section 267(d) does not apply when the loss is not allowable to the transferor as a deduction by reason of the wash sale rules. As a result of this coordination rule, the related party would not benefit from the reduction of gain normally provided by Section 267(d) where the taxpayer sells loss property to a related person and also acquires, within the wash sale period, substantially identical stock or securities. Instead, the more favorable basis adjustment rule contained in the existing version of Section 1091(d) would apply, benefiting the taxpayer directly through an increase in the basis of the substantially identical stock or securities the taxpayer acquired.

Although the relatedness definitions in Section 267 and in the Proposed Wash Sale Rules would overlap significantly, they would differ in certain respects. For example, siblings are included in the Section 267 related party definition, while dependents would be included in the related party definition in the Proposed Wash Sale Rules.

Perhaps unintentionally, a direct sale by a taxpayer to a related party could, if the Proposed Wash Sale Rules were enacted, be disallowed under both Section 1091(a) and Section 267(a), assuming the transferee is related under both definitions. The sale would clearly be subject to Section 267(a), and arguably, because the related party would have purchased substantially identical specified assets within the wash sale period (i.e., the direct purchase of the specified asset from the taxpayer), the loss would fall within Section 1091(a) as well. If the taxpayer also purchases substantially identical specified assets within the Repurchase Period, the Basis Adjustment Rule of Section 1091(c) would appear to apply, permitting the taxpayer to benefit from its loss through a basis increase in those assets. In effect, the wash sale rule would take precedence over Section 267. Although it is not clear that this result is intended, the conclusion is consistent with the coordination rule in Section 267(d)(2).

However, if the taxpayer does not purchase substantially identical specified assets within the Repurchase Period but the related party transferee later sells the asset at a gain, because the original transaction could be treated as a wash sale, Section 267(d) would appear to be

²⁴ I.R.C. § 267(a)(1).

inapplicable due to the coordination rule of Section 267(d)(2). In that fact pattern, the taxpayer and its related party would be denied both the benefits of the proposed Section 1091(d) basis increase as well as the Section 267(d) gain reduction. Under current law, the coordination rule operates appropriately because the taxpayer obtains a basis increase whenever a wash sale occurs, and therefore the coordination rule avoids duplicating that benefit. However, under the Proposed Wash Sale Rules, the application of the coordination rule and resulting denial of benefits under Section 267(d) does not make sense if neither the taxpayer nor the related party obtains a basis adjustment under Section 1091.

If the same transaction (i.e., a direct sale to a related party) occurs, but the parties are related only for purposes of Section 267 and not for purposes of Section 1091 (e.g., if they are siblings), the taxpayer would not be able to obtain a subsequent loss (assuming it is not subject to Section 267(f), which applies under current law only to controlled groups of corporations). Rather, the related party could benefit from the gain reduction rule in Section 267(d).

Moreover, while Section 267(a) clearly applies to a direct sale of an asset by a taxpayer to a related party, courts have also applied Section 267(a) to situations that more closely resemble related party wash sales. Specifically, courts have interpreted the concept of an “indirect” Section 267(a) sale to include sales and pre-planned repurchases effected by family members on a nationally recognized stock exchange. In *McWilliams v. Comm’r*, a husband ordered a broker on several occasions to sell certain stock for the account of himself or his wife, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible.²⁵ The sales were negotiated on a stock exchange and the identities of the persons buying and selling were unknown.²⁶ The Supreme Court disallowed the loss under Section 267(a), rejecting the argument that the sales were bona fide sales to the public for fair consideration rather than indirect sales between spouses.²⁷ As a consequence of this case law, although there is no related party wash sale rule under current law,²⁸ a sale by one taxpayer on a public market followed by a repurchase on the same market by a related party can potentially result in the harsher consequence of loss denial under Section 267(a).

Should the Proposed Wash Sale Rules be enacted, a market sale by a taxpayer and market purchase by a related party could potentially be subject to both Section 1091(a) and Section 267(a) under *McWilliams*. The following example illustrates the need to modify the Proposed Wash Sale Rules to account for the interaction between Section 267(a) and Section 1091.

Example 2. On Day 1, Party A sells specified asset X to an unknown party on a nationally recognized exchange at a loss. On Day 2, as part of a plan, Party B (Party A’s spouse) buys specified asset X on nationally recognized exchange from an unknown party. Both

²⁵ 331 U.S. 694 (1947).

²⁶ *Id.*

²⁷ *Id.* The taxpayer before the court in *McWilliams* observed that the wash sale rules would allow a more lenient result in the case of a taxpayer itself selling and buying back the same security after 30 days. See also *Sethar v. Comm’r.*, 28 TC 1222 (1957); *U.S. v. Norton*; 250 F.2d 902 (5th Cir. 1958); *Merritt v. Comm’r.*, 47 T.C. 519 (1967); *Hassen v. Comm’r.*, 63 T.C. 175 (1974).

²⁸ Although the current wash sale statute does not contain any related party rule, the Internal Revenue Service (the “IRS”) has taken the position that an individual taxpayer and the taxpayer’s individual retirement account were related for wash sale purposes. See Rev. Rul. 2008-5, 2008-1 C.B. 271.

the Proposed Wash Sale Rules and Section 267 (via the *McWilliams* case) would appear to disallow the loss. Under the Proposed Wash Sale Rules, however, if Party A or Party B acquires a substantially identical asset within the Repurchase Period, that party would appear to benefit from a basis increase equal to the foregone loss, assuming the loss is treated as having been disallowed under Section 1091(a). As in the case of a direct sale to a related party, the gain adjustment rule of Section 267(d) would appear to be turned off by reason of Section 267(d)(2). As a result, the interaction between these two rules would result in the wash sale rules taking precedence.

If, instead, Party A and Party B are related corporations, it is unclear whether the Basis Adjustment Rule of proposed Section 1091(c) or the loss deferral rule of Section 267(f)(2) takes precedence, because Section 267(f) does not contain a coordination rule similar to that of Section 267(d)(2).

In summary, as a result of the enactment of the Proposed Wash Sale Rules, each of the three loss disallowance rules – Section 1091, Section 267(a) and Section 267(f) – would apply a different regime to determine whether and to what extent the taxpayer (or the related party) ultimately recovers the loss at issue, and the determination of which regime applies would not be governed by any clear unifying principle.

As a general matter, we believe there is no good policy reason for the permanent denial of an economic loss to a taxpayer once it and its related parties, howsoever defined, have genuinely disposed of the property at issue. Thus, we favor a regime that achieves deferral, rather than permanent disallowance, and leaves the loss with the original taxpayer rather than transferring it to a related party. Of the regimes above, Section 267(a) fails both of these policy goals: it potentially results in permanent disallowance of the loss, unless mitigated by Section 267(d), and it potentially allows for transfers of tax benefits from the taxpayer to a related party.

As discussed above, we recommend replacing the Basis Adjustment Rule with a rule based on Section 267(f), which would apply to all transactions subject to Section 1091. This approach would eliminate the gap described above and would give full effect to the directive of Section 267(d)(2) that Section 1091, rather than Section 267(a), should apply whenever the two regimes potentially overlap. Thus, this approach would meet the policy goals described above and would engender consistency of result among related party transactions as well as single taxpayer wash sales.

Although we appreciate that a broader reworking of Section 267 may be outside the scope of Congress's focus at this time, we would support more comprehensive changes to Section 267 to eliminate Section 267(d) and instead expand Section 267(f) principles so that they apply across the board. As discussed above, Section 267(a), even with the mitigation afforded by Section 267(d), is unduly harsh and not supported by any sound policy. Moreover, by transferring tax benefits to the related party, Section 267(d) can on occasion produce inappropriate taxpayer-favorable results.

B. Changes Relating to the Expansion of the Scope of “Specified Assets”

1. Inclusion of Foreign Currency

We generally support the expansion of the scope of the wash sale rules beyond stock and securities to include commonly held investment assets such as commodities and, subject to the discussion in the next section about the business needs exception, digital assets. With respect to foreign currency, however, we question whether in many common situations the benefit of curbing possible wash sales is worth the compliance burden this new requirement may impose on taxpayers. Foreign currency, unlike commodities, performs a function for investing taxpayers beyond that of a mere investment asset. Investors in stock and securities may hold foreign currency for temporary periods in connection with their purchases, sales and receipts of dividends and interest on stock or securities denominated in foreign currency. The new regime would require potentially significant tracking obligations in respect of small losses.²⁹ While we believe that the policy concerns underpinning the wash sale rules apply to foreign currencies just as to other investment assets, these practical considerations distinguish foreign currencies to some extent from other investment assets by presenting a tradeoff between wash sale policy and compliance burdens in at least some cases. Accordingly, we recommend further consideration of the tradeoffs involved in applying the wash sale rules to foreign currency losses that are incidental to investments in stocks and securities that are denominated in foreign currency before enacting such an expansion.

2. The Business Needs Exception

a) Expansion of the Business Needs Exception to Cover Digital Assets

We support the addition of the Business Needs Exception to Section 1091, but recommend that this exception be expanded to cover digital assets. As in the case of foreign currency and commodities, we understand that there are business uses for digital assets outside of the investment context. For example, businesses may accept bitcoin or other cryptocurrencies as a form of currency in the purchase and sale of consumer goods.³⁰ Other companies may use digital currencies to facilitate international payments.³¹ We acknowledge that, as digital assets are relatively new, their use in ordinary business activities is less well-established than that of

²⁹ The Business Needs Exception excludes traders in foreign currency, but does not appear to exclude traders in other assets, such as stocks and securities, that hold foreign currency directly related to their business needs. As a result, the practical concerns outlined above would be relevant for investors rather than traders in stocks and securities. Although sophisticated taxpayers may be able to avoid the impact of the Proposed Wash Sale Rules in these circumstances by electing to mark to market foreign currency gain or loss under Prop. Treas. Reg. § 1.988-7, this solution may not be practicable for many investors.

³⁰ See, e.g., Joe Woelfel, *AMC Begins Accepting Bitcoin and Ethereum as Online Payments. Dogecoin Is Next*, BARRON'S (Nov. 12, 2021, 1:16 PM), <https://www.barrons.com/articles/amc-bitcoin-ethereum-dogecoin-online-payments-51636710311>.

³¹ Asheesh Biriya, *Crypto Liquidity Is Ready to Eat Cross-Border Payments' Lunch*, TECHCRUNCH.COM (Sept. 27, 2021, 5:44 PM), <https://techcrunch.com/2021/09/27/crypto-liquidity-is-ready-to-eat-cross-border-payments-lunch/>; Carla Mozée, *Nearly 60% of Multinational Companies are now Using at Least 1 Cryptocurrency for Cross-Border Payments, Study Shows*, MARKETS.BUSINESSINSIDER.COM (Nov. 29, 2021, 4:10 PM), <https://markets.businessinsider.com/news/currencies/multinationals-cryptocurrencies-bitcoin-ether-study-cross-borders-transactions-pymnts-2021-11>.

foreign currencies and commodities. Nonetheless, we believe that foreclosing the possibility of a business needs exception for digital assets, as the current statute does, would not reflect sound tax policy. As part of the regulatory process, Treasury can establish the scope of the business needs exception as well as standards of evidence for a taxpayer to demonstrate that it falls within the exception, and thereby distinguish between genuine business use and speculative activity. A taxpayer meeting these standards with respect to digital assets should be eligible for the exception to the same extent as with foreign currency or commodities. For these reasons, we recommend expanding the Business Needs Exception to include digital assets.³²

b) Application of the Business Needs Exception to Business Needs Acquisitions

Under the proposed Business Needs Exception, the exception applies in the case of “any sale or other disposition.”³³ The rule, therefore, considers the sale transaction but not the reacquisition transaction. Treasury regulations are necessary to clarify the application of the Business Needs Exception to reacquisition transactions involving related parties.

Example 3. Party A sells FC on Day 1 in a transaction that did not directly relate to the business needs of a trade or business of Party A. Within the wash sale period, Party B (a related party) purchases substantially identical FC in a transaction that is directly related to the business needs of Party B’s trade or business. As drafted, it is not clear whether Party A would receive the benefit of Section 1091(h) because Party A’s *sale* was not related to the business needs of a trade or business, despite related Party B’s *acquisition* directly relating to the business needs of Party B’s trade or business.

Although it may be less evident that this situation should be exempted from the Proposed Wash Sale Rules than the situation where the sale is related to the taxpayer’s business needs, we believe that there is a strong case to expand the exception to cover this case. Where the acquisition is in the ordinary course of business, as a definitional matter, it is not conducted with a purpose of enabling the taxpayer to recognize loss while maintaining economic exposure to the specified asset. Moreover, tracking currencies or commodities used in a taxpayer group may be difficult even when the sale transaction is outside the ordinary course of that business but the purchases are ordinary course transactions.

C. Interaction with Holding Period Rule under Section 1223(3)

The Proposed Wash Sale Rules do not address the application of the holding period rule found in Section 1223(3) for specified assets. Section 1223(3) provides that “[i]n determining the period for which the taxpayer has held *stock or securities* the acquisition of which . . . resulted in nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition” the period in which the taxpayer held the *stock or securities* that were the subject of

³² Treasury regulations under the subpart F rules already contain a definition of “business needs” for purposes of determining whether Section 988 gain is taken into account as foreign personal holding company income. While beyond the scope of this Report, Treasury may consider this rule as a starting point for a business needs definition under the Proposed Wash Sale Rules. See Treas. Reg. § 1.954-2(g)(2)(ii).

³³ See RULES COMM. PRINT 117-18, at § 138152(h).

the wash sale is tacked onto the holding period of the stock or securities.³⁴ Guidance is necessary to clarify whether the holding period rule in Section 1223(3) applies to specified assets other than stock and securities in light of the expansion of the wash sale rule to other specified assets.

Example 4. Party A sells Digital Asset X on Day 1 in a transaction that did not directly relate to the business needs of a trade or business of Party A. Within the wash sale period, Party A purchases Digital Asset X1, which is substantially identical to Digital Asset X, in a transaction that did not directly relate to the business needs of a trade or business of Party A. As drafted, it is not clear whether Party A’s holding period for Digital Asset X1 would include Party A’s holding period in Digital Asset X.

D. Grant of Broad Regulatory Authority

With the expansion of the wash sale rules to cover a number of new asset classes as well as related party wash sales, taxpayers will likely need significant guidance from Treasury on various aspects of the operation of the rules. However, as currently drafted, the Proposed Wash Sale Rules do not contain a general grant of regulatory authority to Treasury, but instead reference Treasury regulations in certain limited instances.³⁵

We recommend that Section 1091 provide Treasury broad authority to prescribe regulations or other guidance that are necessary or appropriate to carry out the provisions of Section 1091, including to provide appropriate exceptions to the rules.

One area that is likely to benefit from such guidance is the question of what assets meet the definition of “substantially identical,” particularly as the definition relates to digital assets.

Example 5. Party A sells specified asset bitcoin on Day 1. Within the wash sale period, Party A buys specified asset bitcoin cash. Under the current law relating to the definition of “substantially identical,” should the Proposed Wash Sale Rules be implemented to cover digital assets, it is unclear whether bitcoin and bitcoin cash are substantially identical.

Example 6. Party A sells specified asset bitcoin on Day 1. Within the wash sale period, Party A buys specified asset Ethereum. Under the current law relating to the definition of “substantially identical,” should the Proposed Wash Sale Rules be implemented to cover digital assets, it is unclear whether bitcoin and Ethereum are substantially identical.

Section 1091 and the accompanying regulations do not define “substantially identical.” Treasury Regulations Section 1.1223-1(d)(1) provides that “[o]rdinarily, stocks or securities of one corporation are not considered substantially identical to stocks and securities of another corporation.”³⁶ In certain situations, for example, in the case of a reorganization, the regulations

³⁴ I.R.C. § 1223(3) (emphasis added).

³⁵ See RULES COMM. PRINT 117-18, at § 138152(f)(3).

³⁶ Treas. Reg. § 1.1223-1(d)(1) (“In general, as applied to stocks or securities, the term [‘substantially identical property’] has the same meaning as the term ‘substantially identical stock or securities’ used in §1091, relating to wash sales of stocks or securities.”).

provide that predecessor and successor stock may be substantially identical.³⁷ IRS guidance has interpreted the meaning of substantially identical to mean having no materially different features.³⁸

In the context of an exchange governed by Section 1031, the IRS has ruled that the digital assets Ethereum, Litecoin and bitcoin are not “like kind.”³⁹ In making this determination, the IRS explained that “while Bitcoin and Ether share similar qualities and uses, they are fundamentally different from each other because of the difference in overall design, intended use, and actual use.”⁴⁰ The ruling goes on to say that the “Bitcoin network is designed to act as a payment network for which Bitcoin acts as the unit of payment” while Ethereum’s blockchain “was intended to act as a payment network and for operating smart contracts and other applications.”⁴¹ The ruling distinguished Litecoin from both Ethereum and bitcoin because Ethereum and bitcoin serve as an “on and off ramp” for investments and transactions in other cryptocurrencies like Litecoin.⁴² It is unclear whether the IRS’s guidance under Section 1031 could be used by analogy to apply the “substantially identical” test under Section 1091. Treasury regulations are thus necessary to clarify the meaning of substantially identical in the context of digital assets.

The addition of a broad array of derivative contracts to the scope of the wash sale rules will also require difficult determinations about whether one derivative contract is substantially identical to another such contract. Like securities, derivatives have a maturity date and an obligor or counterparty, but unlike most securities they relate to an underlying reference property. Therefore, existing wash sale authorities are unlikely to provide clarity to taxpayers as to whether differences in these elements prevent two derivatives from being substantially identical to each other. Accordingly, regulatory guidance regarding the “substantially identical” definition will likely be important to the proper functioning of the modified wash sale rules.

³⁷ *Id.*

³⁸ See Rev. Rul. 58-211, 1958-1 C.B. 529 (evaluating whether two bonds were substantially identical for purposes of the wash sale rules).

³⁹ See Chief Counsel Advice No. 202124008 (June 18, 2021).

⁴⁰ *Id.* at 3.

⁴¹ *Id.*

⁴² *Id.*