



IRS APPLIES WASH SALE RULES TO IRAS, AND MAYBE TO OTHER DIRECTED ACCOUNTS

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Scrub-a-dub. Cruel experience teaches many of us about the wash-sale rule of IRC Section 1091. It comes into play when a taxpayer (1) sells securities at a loss, and (2) purchases substantially identical securities within 30 days before or after the sale.

Unless the taxpayer is a dealer in securities, Section 1091 disallows the loss. The loss which could have been claimed is treated as additional cost-basis for the retained securities.

Example: Jack sells 200 shares of IBM at a \$10,000 loss. Within 30 days, he buys back 200 shares of IBM for \$20,000. The \$10,000 loss is disallowed, and Jack now has a \$30,000 basis in his newly purchased IBM shares.

Some taxpayers were circumventing this rule. They would sell shares of stock or a mutual fund in a taxable personal account at a loss, and buy back identical shares within 30 days in an exempt retirement account, like a traditional IRA or Roth IRA.

[IRS Revenue Ruling 2008-5](#) closes the door on this one. In fact, IRS now makes such sales the worst technique of all when the replacement shares are bought in an IRA account. The loss on sale of personal shares is disallowed, and the increase in cost basis in the traditional or Roth IRA is valueless. Sales within IRAs do not trigger capital gains tax, so an increase in their cost basis for taxable gains purposes is irrelevant.

*Example: Dumb Jack sells 200 shares of IBM at a \$10,000 loss. Within 30 days, he buys back 200 shares for \$20,000 in his IRA. The \$10,000 loss is disallowed. Although Jack's IRA now has a \$30,000 cost basis in its 200 IBM shares, that's irrelevant. A sale of the shares within the IRA is non-taxable anyway. Any distribution from the IRA will be taxed to Jack based on the fair value of money he receives. **He has wasted the entire \$10,000 loss.***

It gets even worse.

At the tail end of the ruling, IRS says it does not address issues under IRC 4975. The reference to the prohibited transaction rules is worth noting. If an IRA engages in a Section 4975 prohibited transaction, it loses qualification under IRC 408(e)(2). That makes everything in the IRA, not just the transaction amount, immediately taxable. IRS may be suggesting that an IRA purchase of identical securities is not exclusively devoted to the retirement purpose of an IRA and is a fiduciary

breach by the owner. (See IRC 4975(c)(1)(D) prohibiting use by or for the benefit of an IRA owner of the assets of his IRA.) This is probably just a courteous bit of deference from the IRS to the Department of Labor, which has jurisdiction over 4975 rules which apply to IRAs. I'm not too concerned that a wash-sale would be considered a prohibited transaction. However, those who deal with the Department know that it is hypersensitive to rules of fiduciary propriety. This additional concern simply highlights the reason not to engage in wash-sales with the IRA as purchaser of replacement securities.

What about controlled accounts in other retirement and deferral plans?

The ruling was only addressed to IRAs. However, its reasoning could apply to purchases by employer plans whose assets are controlled by the taxpayer. Consider (1) self-directed 401(k) accounts, (2) qualified plans for which an owner-participant serves as trustee, and (3) directed measurement accounts in a typical "top-hat" deferred compensation plan.

An advisor must consider the underlying rationale of the new revenue ruling. IRS relies on a pair of court cases (cited in the ruling) from the 1930s. These old cases did not involve IRAs, of course, but instead focused on the use of controlled corporations and trusts over which the taxpayer retained "dominion and control." The term "dominion and control" is loose and not well-defined. It has been interpreted to include the power to direct how money will be used or invested, even if a taxpayer is not in constructive receipt for income tax purposes.

Although "dominion and control" will not, of itself, cause a person to be taxed on IRA or other plan assets, it may be all that is needed to trigger the wash-sale rule. It's not clear whether IRS will expand the new revenue ruling. The omission is a good sign, but no promise from IRS that it will not extend Section 1091 to replacement purchases by other directed plan accounts. The counterargument is that, although a taxpayer may have investment powers in 401(k)s and top-hat plans, these type of plans generally operate under restrictions which are significantly different from those which apply to an IRA or personal account. For example, withdrawal rules are more restrictive, whether it's due to the qualified plan regime of IRC Section 401 or "plan failure" concerns for top-hat plans under IRC Section 409A. Owner-trustees of qualified plans are also subject to ERISA fiduciary requirements, at least when the plans cover common law employees in addition to the owner.

Ideally, Section 1091 wash-sale rules should only apply to replacement purchases by IRAs, and should not extend to the other types of directed plans. Conservative taxpayers, however, will take the approach that purchase by any directed account, in whatever form, will trigger the wash sale rule of Section 1091.

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