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Wash Sales With Replacement By Related Parties

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In *McWilliams v. Commissioner* (1947), the Supreme Court held that loss would be suspended when a husband sold stock at a loss and simultaneously ordered his broker to buy the same stock in his wife's account. Under current law, the related party gets the loss added to basis.

The proposal discussed here would make the suspension of loss automatic if a closely related party replaces the sold loss property within 30 days before or after the loss sale, but would preserve the loss for the original seller. That loss would not be recognized until the related party sells the replacement property or the relatedness is broken.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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In a realization system, taxpayers have an incentive to sell loss property from a diversified portfolio and hold gain property. With no limitations on selective loss sales, the effective tax rate on an appreciating portfolio is less than zero. Replacements by related parties are now sometimes treated as ''fake dispositions'' under the facts and circumstances step transaction doctrine, collapsed or not according to whether the sale and replacement are part of an overall plan. The litigation over facts and circumstances is not worth the effort in an efficient, properly priced market. This proposal would make the suspension of loss automatic if a closely related party replaces the sold loss property within 30 days before or after the loss sale.

Current law also gives the purchaser of the replacement property added basis for the loss not allowed on the sale, subject to increasingly complicated rules limiting loss-shifting from one party to another. It is simpler and better theory to let the original seller take the loss, but not recognize it until the related party sells the replacement property or the relatedness is broken. There would never be a transfer of basis to the related party. Also, section 267(d) would be amended to conform to this proposal so that the original owner keeps a suspended loss both on replacement by the related party and a sale to the related party.

An appendix proposes draft statutory language.

A. Current Law

1. Deferring losses on wash sales. Section 1091 on wash sales defers a loss realized by a taxpayer on a sale of stock or securities if the taxpayer replaces the loss property with substantially identical property within a 61-day window, extending 30 days before and 30 days after the sale. The basis for the loss is added to the basis of replacement property, however, so that the loss is allowed when the replacement property is ultimately sold.

Section 1091, on its face, requires repurchase of the replacement property by the *same taxpayer*. If a closely related taxpayer buys the replacement property, the courts have sometimes been willing to treat the replacement as an indirect sale to the related party, even though the sale and replacement are both transactions on a public market. Section 267(a)(1) disallows losses on direct or indirect sales to specified related parties. In *McWilliams v. Commissioner*, 331 U.S. 694 (1947), for instance, the taxpayer directed his broker to sell blocks of stock he held in his own name and to buy the same stock in his wife's name. The taxpayer managed his wife's separate estate. The Supreme Court held that the sales were indirect sales to his spouse.

Before *McWilliams*, other courts were willing to deny the loss when the husband had control and dominion over his wife or gave the buy order for the replacement,[1] but not when the wife decided on the replacement purchase on her own and used her own funds.[2] The courts have also denied a loss for replacements that are part of a plan when replacement of substantially identical

[1] *Mitchell Estate v. Commissioner*, 37 B.T.A. 161, 166-167 (1938) (selling husband had dominion and control over wife); *Morse v. Commissioner*, 34 B.T.A. 943, 945-946 (1938).

[2] *Young v. Commissioner*, 34 B.T.A 648, 652-653 (1936); *Behan v. Commissioner*, 32 B.T.A. 1088, 1091-1092 (1935).

stock is by a controlled corporation[3] or by a controlled trust.[4] Under current law, loss on a sale from a parent to a child is disallowed under section 267(a)(1) and (b), but a replacement by a child who is not in the household is not always disallowed. *Cote v. Helborn*,[5] for instance, allowed a father to take a loss on a sale, although he loaned his son the money to repurchase the same stock the next day.

Recent cases treat the indirect sale issue as a step transaction question. Replacements made as a part of a single plan are collapsed to become indirect sales, but repurchases separated by some time from the loss sale, made with the related party's independent funds and by reason of an independent decision by the related party, do not cause the initial loss to be disallowed.[6] Under the case law, some replacements within the 61-day window that section 1091 uses to identify wash sales are not indirect sales. In *United States v. Norton*,[7] for instance, the court sustained the disallowance of the loss when the replacement was by the taxpayer's mother the same day as the sale, but not when she replaced stock 28 days later in a purchase not contemplated at the time of the loss sale.

Without some doctrine finding indirect sales, section 267(a)(1), disallowing losses, would become a nullity for publicly traded stock because the parties can always sell and replace stock on the public market at reasonable price and do not need to sell privately from one related party to the other.

Section 1091 might be thought of as a *per se* step transaction rule, collapsing the sale and repurchase by the same taxpayer within a 61-day period into a single nonsale of the security automatically. When the replacement is by a closely related party, however, the disallowance of the loss is not automatic under current law.

The judicial indirect sale rule is triggered only by an IRS agent asserting the disallowance on audit. Given the rarity of audits, and that an audit does not easily pick up replacements by related parties, application of the judicial indirect sale, step transaction rule has to be as rare as a hen's tooth, or at least much rarer than application of the automatic 61-day window rule in section 1091.

2. Basis. The logic of sections 1091 and 267(a)(1) is that the loss is suspended because the taxpayer has not truly given up the loss property. Both provisions add the basis disallowed in the loss sale to the replacement property. Section 267(d), however, has some rules against "trafficking in loss," whereas section 1091(d) dealing with a single taxpayer adds the *whole* disallowed loss to the replacement property to be used when replacement property is sold. There have also been some additional anti-loss-shifting rules in the last four years, and logically, section 267(d) should be conformed to those rules or another approach should be used (as recommended here).

Section 267(d), governing a sale to another taxpayer, imitates the section 1015 gift split basis rule. Section 1015 gives the donee the donor's full basis in computing gain, but if the donee sells for a loss, section 1015 strips the donee's basis of the loss built into the property at the time of the gift. The donor's loss at the time of the gift can be used as a shield (for gain), but not as a sword (generating loss). Under section 1015, sales by the donee between fair market value and the higher donor's basis are in an accounting black hole with neither gain nor loss. This is a split basis or anti-loss-trafficking rule, a 1921 experiment, in which there is different basis for gain and for loss.[8] Now the usual rule since the 1921 experiment is "unified basis" that is the same basis for all purposes.

Section 267(d) replicates the section 1015 result for related-party sales by giving the related-party basis for the disallowed loss only for the purpose of subsequent gain. If the replacement property never recovers from the built-in loss to sell above the donor's original basis, the loss on the original sale disappears for tax purposes. As under section 1015, the subsequent sale produces neither gain nor loss for a sale between the original cost and the fair market value of the property as of transfer. A purchase by a related party is not a gift by the seller because the purchaser is paying full fair market value, but section 267(b) still employs the split basis logic used for gifts.

The split basis of section 1015 is applied by section 267(d) not just for what might be thought of as gift relationships, but also for sale to or replacement by, for example, a controlled corporation. There is a special rule for a sale from one corporation to another within the same 50 percent controlled group, under which the loss is deferred until the stock or security leaves the control group.[9] But sales by an individual shareholder, with replacement by a 50-percent-controlled corporation, are governed by the same section 267(d) rule: The seller's loss transfers to the buyer and may be used to compute gain, but not to compute loss.

When section 267(d) was adopted, disappearance of the loss when a corporation purchased the loss stock was a strangely taxpayer-adverse result because section 362 gave the entity the full basis of the contributing owner, even when there was loss built into the property on contribution. Now the same rule is a strangely taxpayer-friendly result. The 2004 amendment of section 362 to prevent a corporation from getting a shift of a shareholder loss was inspired partly by the Long Term Capital Holding Co. hedge fund, which created artificial accounting losses and then cloned the losses by contributing loss property to a corporation or partnership.[10] In response,

[3] *Kaplan v. Commissioner*, 12 T.C. 134, 141-142 (1953) (replacement 15 days after loss sale).

[4] *Securities First National Bank of Los Angeles v. Commissioner*, 28 B.T.A. 289, 313-315 (1933) (purchase by trust controlled by taxpayer who sold stock at a loss to his corporation).

[5] 4 F. Supp. 230 (W.D. Ky. 1933).

[6] *Hassen v. Commissioner*, 599 F.2d 305, 309 (9th Cir. 1979) and cases therein discussed.

[7] 250 F.2d 902, 909 (5th Cir. 1958).

[8] Section 1015 has no effect on the shifting of gain to lower-bracket related parties, so section 1015 neglects the greater problem and works on the rarer problem.

[9] Section 267(f)(2)(B).

[10] *See, e.g.,* Alvin C. Warren Jr., "Understanding Long Term Capital," *Tax Notes*, Feb. 7, 2005, p. 681, *Doc 2005-1626*, *2005 TNT 25-48*.

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Congress limited the basis of a corporation for property contributed by a shareholder to fair market value of contributed property. Section 362(e)(2)[11] now provides that the controlled corporate transferee of property cannot get basis for loss built into the property on contribution.[12] Section 267(d), however, was not amended to conform to the logic of the 2004 changes, although it should have been. Logically, the 2004 amendment to section 362 implies that the entity replacing loss property should be denied the shift in basis from the taxpayer, even if the related party ultimately sells for a gain. The proposal explained below, which gives only the original selling taxpayer a basis, is much simpler and obviates the need to conform section 267(d) to the recent section 362(e)(2) changes.

Section 267(d) does not increase the basis of the loss-selling taxpayer in the shares of the corporation that has the replacement property. Any appreciation in the value of the replacement property will add to the capital gain on the stock. Section 267(d) prevents the replacing corporation from recognizing gain because of the deferred loss, but it does not prevent the taxpayer who actually sold the property at a loss from avoiding capital gain. Loss below the corporation's purchase price will produce a loss both on the corporate level and on the shareholder level. Again, preserving the loss for only the original shareholder with a deferred loss account would obviate the need to adjust outside basis in stock, as well as inside basis of the purchasing corporation itself.

There is a parallel problem for partnerships. For partnerships, the function of loss disallowance for indirect sales to related parties is accomplished by section 707(b) rather than section 267. If a 50-percent partner sells to the partnership at a loss, the loss is disallowed and then the partnership gets the disallowed loss added to its basis for the replaced property.[13] As under section 267(d) itself, the basis can be used only for gain, and not to give the partnership a loss. There are, however, no basis adjustments on the level of the partnership interest. That leads to a rule in which the partnership can avoid recognition of gain, but the partner cannot. A partnership that sells property and distributes the proceeds will cause the partner to recognize gain, by the amount of the transferred basis from the original loss sale.

Section 707(b) also has not been conformed to new 2005 anti-basis-shift limitations. Section 704(c)(1)(C)[14] prevents other partners from getting a basis in contributed built-in loss property beyond fair market value of the property. Section 704(c)(1)(C)(ii), however, allows the partner in whose hands the loss arose to use full basis (including the loss) for his own tax calculations. Conforming 707(b) to the 2004 amendment of section 704(c) would require that the partnership not be entitled to use the loss partner's basis, but the proposal below would create a simpler rule, allowing the taxpayer who made the loss sale to take the loss at a later point.

If the replacement is by the taxpayer himself, section 1091(d), by contrast, adds the full loss disallowed by the wash sale rule to the basis of the replacement property. In this case, there is no concern about shifting losses, so that basis from the loss property can be used for both gains and losses on the sale of the replacement property. The generosity of section 1091(d), adding full basis in all cases, is, however, inappropriate for basis-generating losses for some other taxpayers.

B. Reasons for Change

1. Automatic 61-day window. The wash sale rules, and related-party rules, are limitations to control taxpayer loss harvesting. In a realization tax system, a taxpayer can realize losses annually, and defer all gains indefinitely. The asymmetrical treatment of losses and gains allows a taxpayer to report tax losses, even when an overall investment portfolio is appreciating. The asymmetrical treatment gives an incentive to move to higher-volatility investments to increase the value of the tax asymmetry. With unlimited allowance of selective realization of losses only, the effective tax rate on an appreciating portfolio is less than zero.

Both the wash sale rules of section 1091 and the related-party rules of section 267(a)(1) collapse a sale and replacement into a single event, as if the taxpayer had not really sold the property. Section 1211, generally deferring capital losses until the taxpayer reports capital gain, is a more effective anti-loss-harvesting remedy because it applies whether or not loss property is replaced. For taxpayers with substantial capital gains for unrelated reasons, however, section 1211 does not defer a loss. Sections 1091 and 267(a)(1) prevent a taxpayer from shielding capital gain with sales that are in some sense fake dispositions.

Both sections 1091 and 267(a)(1) can be avoided at minor cost. A taxpayer can wait 31 days to replace a stock and avoid the window of section 1091. If a taxpayer sells stock of Southern Pacific Railroad and buys stock of Northern Pacific Railroad, there is no deferral of the loss because the replacement property is not substantially identical to the loss sale property. The efficient market thesis implies that any known differences between Southern Pacific Railroad and Northern Pacific Railroad are fully reflected in their price, so that one stock can be expected to be a near-perfect substitute for the other. If a taxpayer has a capital gain, the value of avoiding the gain by recognizing the loss implies that the taxpayer would not avoid loss harvesting, but would just avoid the loss deferral limitations. Given the seriousness of the loss harvesting problem, suspension of losses on fake dispositions is rational, but the limited role of the wash sale and indirect sale limitations means the sections need to apply automatically, or not at all.

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[11]Section 362(e)(2), added by the American Jobs Creation Act of 2004, P.L. 108-357, section 836(a).

[12]New section 362(e)(2)(C) allows the transferee corporation and the shareholder corporation to elect jointly that the shareholder will give up the built-in loss, and then the corporation will get it. The section 362(e)(2)(C) election is pure rate arbitrage: The election would be made only because the loss is more valuable to the 35-percent-tax-rate corporation than to the shareholder and because that election seems inconsistent with the deeper anti-loss-trafficking norm at work in section 267(d) more generally.

[13]Section 707(b)(1).

[14]Section 704(c)(1)(C), added by the American Jobs Creation Act of 2004, section 833(a).

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Application of the step transaction rule, as in *McWilliams,* requires audit identification of the issue, and facts and circumstances litigation. The auditor must find evidence of an overall plan unifying the sale and replacement. The rule cannot be enforced merely by stating a clear objective rule on the tax return instructions or in the automatic way that rules captured by the tax return are enforced. The nature of the rule means that taxpayers in identical situations will be treated differently.

The proposal here would replace the common-law step transaction rule of *McWilliams* with an automatic 61-day rule having a narrower definition of related parties. Brothers and sisters, for example, would not be related.

2. Basis shifts. Limitations are necessary on moving basis from the taxpayer, in whose account the losses occurred, over to a related party. The party who invested and has basis may be in a lower bracket, or have too many net operating losses to use losses or may be a foreign party, whereas the related party could use the losses more profitably. Especially with the new 2005 limitations on loss-shifting to a corporation or through a partnership, applying the limitations on top of a basic section 267(d) rule (shifting basis to the related party) can get very, very complicated. The section 1015 rules, even once they are applied, are inconsistent because they allow shifting of basis in calculating gain. It is simpler and better theory to keep the losses in the hands of the original seller. Section 267(d), shifting basis to the related party who has the replacement property, is prone to abuse by intentional sales of loss property to related parties just so that the basis will be usable by the related party. Instead of attaching the loss as added basis of replacement property, the proposal treats the loss as a suspended loss, usually capital loss, to be taken by the original taxpayer but only when the property leaves the group or the holder of the property ceases to be a member of the economic group.

C. Explanation of the Proposal

1. Automatic rule. It is proposed that replacement of sold loss property by a closely related party (for example, a spouse with whom a taxpayer files a joint return, or a dependent) would be automatically a wash sale if the replacement occurs within 30 days before or after the loss sale. The 61-day window comes from section 1091, applicable literally to replacements by the taxpayer itself. Creating a per se rule when a related party replaces the stock would simplify the antiabuse step transaction inquiry the courts now apply and would make it possible to administer the rule. The step transaction fact inquiry is subjective and multifaceted. It encourages wasteful litigation and inconsistent application. A 61-day window incorporated on the tax return instructions will have greater effect sociologically and it can be enforced by plausible penalty. The IRS might be able to prove a step transaction even when the replacement occurs outside the window, but undoubtedly that will happen rarely.

2. Related party. The related-party rules of section 267(b) are broader at the edges than would be appropriate to make all 61-day replacements the occasion for denying loss. For instance, brothers and sisters are related under section 267(b).[15] Brothers and sisters do not keep track of each other's stocks once they leave home, with the possible rare case regarding a joint business enterprise. If the taxpayer does not know of the sale, there is no voluntary compliance with the loss denial. Indeed, section 267(b) aside, replacement by a sibling not in the household would not ordinarily be considered a return to a ''substantially identical'' position, which is the general standard under section 1091 to judge whether replacements trigger the wash sale disallowance.

The section 267(b) definition of related party is too broad for an automatic rule in other ways. Partners own each other's stock.[16] That means that a sale to a corporation half owned by a partner in an equal-share, two-person partnership is a loss disallowance sale. The statutory judgment is that real sales between those related parties are not occasions for recognition of the loss. Assuming the correctness of that rule when there is a real sale, replacement by a corporation half owned by a partner within the 61-day period is still not an event the taxpayer would ordinarily know about. It also does not seem to leave the taxpayer selling at loss in a substantially identical position. The facts and circumstances step transaction doctrine might well make some of those replacements an indirect sale, if part of an overall scheme, but an automatic rule is too harsh at the outer edges of section 267(b).

The following includes detailed issues of relatedness covered by the proposal:

a. Joint returns. Some replacements do seem so tantamount to replacement by the taxpayer himself that the automatic rule of the section 1091 61-day window should apply. If spouses file a joint return, for example, they have elected to treat their incomes as commingled enough to account for the two incomes, gains, and expenses as if they were one. Sale by one spouse and replacement by another within the 61-day window should be automatically treated as replacement triggering the wash sale disallowance if they file a joint return. Indeed, a joint return either in the year of the sale or the year of the replacement, and a joint return within the last two years of a couple that has not separated, should also be treated as requiring automatic application of the section 1091 automatic 61-day rule. No proof of facts and circumstances of the sale should be required or accepted. The proposed amendment to section 1091, included in the Appendix, says that if the spouses file a joint return, or have filed a joint return within the last two years and are members of the same household for more than half of the tax year of sale or replacement, the automatic 61-day window applies even in the absence of any evidence that there is a common plan or coordination of sale and replacement.

Applying the 61-day replacement window to less than all replacements by spouses makes the rules for replacements different from the rules disallowing losses for

[15]By contrast, brothers and sisters are not related under section 318 (testing whether redemptions are in fact pro rata dividends).

[16]Section 267(c)(3).

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indirect sales. Under section 267(c)(4), all spouses are related parties. The effort to define the scope of the 61-day automatic rule creates another set of related-party rules that is narrower than those applied by statute under section 267(a)(1) for direct and indirect sales. Once it is conceded that an automatic disallowance rule should not apply to replacement by an estranged spouse but should apply to replacement on the same joint return, then the effort to define the scope of the automatic 61-day window needs to be undertaken.

Under the proposed remedy, the loss would be allowed to the original spouse when the replacement property leaves the couple, or the couple ceases to be related parties.

b. Dependents. Section 1(g)(7) allows parents to include the unearned income of dependents under 18 years old on their own tax return. As with a joint return, the election to consolidate with a child should be sufficient to mean replacement with the 61-day period by or for the child is tantamount to replacement by one taxpayer under section 1091. Children in the household, however, are not in fact independent, even if no section 1(g)(7) election is made. Under section 1(g), the child must pay tax at the parents' tax rate for unearned income, up until age 18, and that single rate is a reflection of the economic unity of a household. Dependent children living in the household should be considered a part of the same economic group as the taxpayer. Replacement for or by dependent children in the household should fall within the automatic 61-day window rule.

A reasonable definition of relatedness for application of the 61-day window is the definition of dependent in section 152. Under that provision, dependents must ordinarily live in the home for more than half the year and get more than half of their support from the taxpayer and bear some family relationship to the taxpayer. The proposed definition of dependent does not exactly overlap with the related-party rules of section 267(b). Stepbrothers and stepsisters can be dependents of each other under section 152 but not under section 267(b). The section 152 requirement that the stepsiblings live in the same home and provide half the support makes it seem reasonable to apply the automatic 61-day wash sale rule for replacements by or for dependents. Any time a taxpayer sells and any dependent replaces or vice versa within the 61 days, loss should be suspended. Sales between two dependents of the same taxpayer should be reached automatically. As with the spousal rules, the deferred loss should be allowed when the replacement is sold not in a transaction in which loss is further deferred, and if the child leaves the household. The parent would be expected to know when the child in the household has disposed of the replacement stock, so that the deferred loss is finally allowed.

c. Entity replacements. Replacement by a 50-percent-owned corporation should be tantamount to replacement by the taxpayer as well. At 50 percent, the taxpayer has the majority of the votes of the corporation so that all corporate officers must act as agents of the taxpayer. The related-party rules of section 267(b) apply to disallow losses on direct sales on 50-percent ownership of a corporation, and sections 267(a)(1) and 1091 have the same rationale of denying loss because of the taxpayer's continuing interest. No proof would be required that the taxpayer and related partnership planned the replacement together or that a repurchase was considered when the loss sale occurred. A partner and a 50-percent-owned partnership should also be treated as related to each other. Again, the proposed rule would allow the shareholder the deferred loss when the corporation disposes of the replacement property or breaks the relationship with the shareholder.

Sale by a trust followed by replacement by the beneficiary or vice versa should also always be within the 61-day window rule. A trust and beneficiary have an economic identity. For example, section 302(c)(2) allows family members to be treated as unrelated when there is a complete termination of a shareholder. Family members can have conflicting interests. But section 302(c)(2) does not permit breaking attribution between a trust and its beneficiary. A trust is an artificial entity with no other economic purpose but benefit to the beneficiary and the trust cannot therefore be looked at as other than an arm of the beneficiary. Again this is a different standard than section 267(b), which also makes grantors related parties with their trust.

d. IRA Replacement. Rev. Rul. 2008-5[17] appropriately held that when a taxpayer sold publicly traded stock and the taxpayer's IRA immediately repurchased the same stock, the transaction was a wash sale under common-law standards and no loss would be allowed to the taxpayer. The ruling needs to be codified by saying the individual and his IRA are related parties. An IRA is appropriately treated as part of the taxpayer's economic group and so is a related party. The individual has access to records and control of purchases and sales by the IRA trust.

Basis should not, however, shift over to the IRA. The trust is a tax-exempt entity that cannot use the loss. Shifting basis from the stock to the IRA would shift basis from a capital asset to an ordinary asset. Under the proposal, the individual taxpayer would be allowed the loss if the IRA disposes of the substantially identical replacement property.

A Roth IRA, governed by section 408A, does not generate a deduction or exclusion for the contribution to the IRA. Subsequent gain or distributions of the Roth IRA are, however, tax exempt. The Roth IRA exemption privilege is of the same value as the regular IRA privileges of deduction of the investment, under the assumption of constant tax rates. No distinction should be made between a Roth IRA and a traditional IRA.

e. Grantor trust. Under the proposal, the automatic 61-day window would apply when a grantor trust replaces the loss sale property (or vice versa). This is intended only to clarify current law and end disputes because that result is appropriate even under current law. Sections 671 through 679 provide that the grantor ''shall be treated as the owner . . . of the trust'' in the attribution of income and deduction. The leading treatise on the issue argues that section 671 should be read broadly so that there is never a tax benefit in creating a grantor

[17]2008-3 IRB 1, *Doc 2007-27913*, *2007 TNT 246-14*.

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trust.[18] To maintain conceptual consistency, the grantor should be considered the owner of the trust for all tax purposes.[19] A grantor trust is a separate pocketbook of the same taxpayer. The ''same person is treated as owning the [stock] both before and after the transaction.''[20] Before the enactment of the automatic rules of section 671, the courts disallowed a loss when a grantor trust acquired the sold loss stock when it was part of an overall plan.[21] The proposal would apply the 61-day window automatically, but the taxpayer would be allowed the loss when either the stock or the trust leaves the related group.

3. No basis-shifting. The proposed new subsection defers the loss when a closely related party replaces the property within the 61-day window. It then gives the loss-sale taxpayer a capital loss when the replacement property is disposed of by the related party or the party ceases to be related. The loss would be a capital loss if the sold asset was a capital asset to the original taxpayer. The holding period of the replacement asset as held by the related party would be added to the holding period of the original taxpayer. The loss might become long-term solely by reason of the replacement.

4. Conform section 267(d) on basis. A sale to a related party and a replacement by a related party should be treated the same regarding basis. Under the proposal, the original taxpayer that invested the basis keeps the loss in a suspense account until the loss property leaves the group. Under section 267(b), the loss basis shifts over to the related party. A taxpayer who wanted the basis to shift over to the related party for tax advantage could, after the proposal is enacted, sell to the related party and avoid having the related party replace the stock. Keeping the loss in the original taxpayer's hands is the better rule and section 267(d) should be amended to conform by creating a suspense account in the hands of the seller.

Appendix: Statutory Amendment

Section 1091 is amended by adding a new subsection (g).

Section 1091(g) — Replacement by Related Party.

(1) Stock, securities, a contract or option acquired by a related party, within the meaning of paragraph (g)(2), shall be considered to be purchased by the taxpayer who sold at a loss, in applying subsection (a). In applying subsection (d) (addition of basis to taxpayer's own property) and paragraph (g)(1) (allowing deferred loss to the selling taxpayer), loss shall be considered to be disallowed first by reason of replacements by the taxpayer and thereafter by acquisitions by the related party.

(2) Related Party. Related parties referred to by paragraph (g)(1) include:

(A) Joint Returns. A spouse with whom the taxpayer selling at a loss has filed a joint return within the year of sale or replacement, or within the prior two years, provided the parties have not separated in the year of the replacement.

(B) Dependents. A dependent of the taxpayer, as defined in section 152, and the taxpayer and other dependents of the taxpayer are parties related to each other.

(C) Corporations and Partnerships. A corporation and shareholder and a partnership and partner are related to each other if the shareholder or partner owns greater than 50 percent of the ownership interest of the entity. In computing the percentage ownership, shares and interests owned by spouses, children and parents, trusts and beneficiaries, or other 50-percent-owned entities and owners shall be constructively owned by each other.

(D) Trusts and Beneficiaries. Trusts and beneficiaries are related to each other. A taxpayer is related to a trust, and vice versa, if a spouse or dependent is a beneficiary. A grantor trust and the owner of the trust are treated as the same taxpayer.

(E) IRA. An individual and an individual retirement account created by or for the individual are related parties.

(F) Additional Related Parties. Additional related parties may be added by regulation.

(3) End of Deferral of Loss. A loss disallowed by application of paragraph (g)(1) shall be allowed to the party who sold the stock or securities at a loss when the related party disposes of the stock, securities, contract, or option that caused the deferral of the loss outside of the related-party relationship, or when the related party ceases to be a related party. The character of the loss shall be determined by the character when the loss stock or securities were originally sold with the holding period of the replacement property tacked onto the holding period for the loss stock or securities.

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[18] M. Carr Ferguson, James Freeland, and Mark Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries,* at 10-51 (3d ed. and 2008 Supp.).

[19] *Id.* at 10-54. *See* prop. reg. section 1.671-2(f) (1996) (grantor considered to be owner of trust assets for all purposes of income tax).

[20] Rev. Rul. 85-13, 1985-1 C.B. 184.

[21] *See* note 4 *supra*.

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