Wash Sales: Considerations in Grant Practices and Forced Sales to Avoid Causing Delay of Employee Loss Deductions

BY KATHLEEN M. EMBERGER AND CAROLINE F. HAYDAY

IRS "wash sales" rules designed to prevent tax manipulation by a taxpayer who attempts to recognize a loss while maintaining an identical or nearly identical investment position demand critical attention in the employment context because an employer may inadvertently subject its employees to the rules, and cause an employee's loss recognition to be delayed, even where the employee has no knowledge of or control over the triggering event.

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Wash Sales: Considerations in Grant Practices and Forced Sales to Avoid Causing Delay of Employee Loss Deductions

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Pursuant to Section 1091 of the Internal Revenue Code of 1986, as amended (the "*Code*"), taxpayers are prohibited from deducting a loss sustained upon the sale or other disposition of stock or securities if, within the 61-day period beginning thirty days prior to, and ending thirty days following, the date of such sale or disposition, the taxpayer acquires, or enters into a contract or option to acquire, stock or securities substantially identical to those sold or otherwise disposed of.[1] These rules, referred to more commonly as the "wash sale" rules, are "designed to prevent tax manipulation by a taxpayer who attempts to recognize a loss while maintaining an identical or nearly identical investment position."[2] In the employment context, these rules may create unexpected consequences for employees.

If the wash sale rules apply to a purchase and sale of securities, the loss is deferred and the basis of the newly acquired securities is the basis of the sold securities, plus the difference (positive or negative) between the cost of the newly acquired securities and the amount realized from the sale of the sold securities.[3] Furthermore, the holding period of the sold securities is tacked on to the holding period of the newly acquired securities. Although in theory the rules operate to defer (*i.e.*, to prohibit only the immediate use of) the loss, in reality, the taxpayer, who will likely be unaware of the disallowance until a subsequent year, may find the loss is either no longer valuable to him or no longer exists because the shares have appreciated in value.

In theory, the rules may seem straightforward: to determine whether a wash sale has occurred, the taxpayer must determine whether the taxpayer has, within the proscribed period, (1) acquired or (2) entered into a contract or option to acquire, (3) stock or securities (4) substantially identical to those sold or otherwise disposed of. In practice, as a result of the sophisticated instruments available on the market today, and the lack of guidance applying the wash sale rules to these instruments, these questions are not always easily answered.

There may be an additional complicating factor in the application of the wash sale rules in the employment context; in particular, the employer's grant of certain equity-based awards to an employee, often without any knowledge or volitional act by the employee, may trigger the provisions of Section 1091 and result in the employee being denied the loss deduction for the employee's sale of stock of the employer. For example, Section 1091 applies if, within the proscribed period surrounding a loss transaction, the seller acquires or *enters into a contract or option to acquire* securities substantially identical to those sold, which presumably would include a compensatory option to purchase employer stock. For purposes of triggering the disallowance of the loss deduction under the wash sale rules, there appears to be no reprieve, and an acquisition or option or contract to acquire may occur, even if (i) the employer is not aware of the employee's sale, (ii) the employee had no knowledge of an impending grant of equity-based awards or (iii) the grant does not require any act of the employee as a condition to its effectiveness.[4] The fact that the option may be subject to vesting does not appear to change the result.[5] Furthermore, pursuant to Section 1091(f), the wash sale rules "shall not fail to apply to a contract or option to acquire or sell stock or securities solely by reason of the fact that the contract or option settles in (or could be settled in) cash or property other than such stock or securities," and thus phantom stock awards and stock appreciation rights do not seem to avoid application of the rules either.

As soon as an employee has notice of the grant, avoiding deferral of the loss deduction is fairly straightforward, assuming that the employee is aware of the rules in the first place, because the employee can simply refrain from selling shares at a loss. It is not always possible to construct a meaningful framework to aid the employee in avoiding the wash sale rules for sales by the employee occurring prior to the grant, however. After all, the employer may not be keen on pre-announcing a decision to make equity awards so far in advance, and it is not always practical to require that grants be made on a certain schedule. Nonetheless, for various reasons likely having nothing to do with Section 1091 of the Code, many companies have moved to a practice of making grants on a fixed date or pursuant to a fixed schedule; a practice that, if adhered to, aids the employee in determining when he can dispose of shares at a loss without triggering the wash sale rules.[6]

These issues can also arise in the context of the acquisition of the employer. For example, in a merger or acquisition in which the target's shares are cashed out, an executive may well sell shares at a loss in the transaction. This loss may be disallowed if, when the employee receives a grant of new equity awards[7] in the successor entity within the proscribed period, the securities of the going-forward entity are deemed substantially identical to the securities of the acquired employer.

The term "substantially identical" is not defined either in the statute or the regulations, and thus whether the securities are substantially identical is a factual question. When considered by the Internal Revenue Service or the courts, the meaning of "substantially identical" has been fairly narrowly construed. In general, common stock of one issuer is not substantially identical to the common stock of another.[8] At least one case has held that the securities of a holding company are not substantially identical to the securities of the operating company, even if the operating company is 100% owned by the holding company and constitutes the holding company's sole asset.[9] However, the mere lack of voting rights is insufficient to treat securities as substantially different.[10] Preferred stock of an issuer may be substantially similar to common stock of the issuer if it is convertible and its value tracks the value of common stock.[11] And options[12] with a different exercise price are not substantially different if the term of the option is the same.[13] Accordingly, in certain instances, it may make sense to delay the grant to employees of equity awards in the surviving entity so that any such awards would not be matched against any sales made at a loss by the same employees in the transaction.

In the current economic climate, where the potential for *bona fide* sales of securities by employees at a loss is greatly enhanced, employers, acquirors and employees alike may wish to be mindful of the wash sale rules. With careful planning, the employee's loss deduction may be preservable, and inadvertent violations of the wash sale rules avoidable.

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1 Section 1091 of the Code and the regulations promulgated thereunder.

2 GCM 38285 (Feb. 22, 1980).

3 For example, assume the stockholder sells 100 shares that he purchased for $100 for $75, and then repurchases 100 shares ten days after the sale for $85. His basis in the newly acquired shares is now $110. If he purchased the shares for $65, his basis in the newly acquired shares would be $90.

4 There does not appear to be any guidance suggesting that, if the effectiveness of the grant is conditioned upon acceptance by the employee, by delaying acceptance until the proscribed period has run, the employee can avoid application of the wash sale rules.

5 Awards of stock subject to vesting conditions that rise to a substantial risk of forfeiture, and the subsequent vesting of the shares, are deemed not to be an acquisition by the employee and thus will not result in a disallowance of the deduction even if the award is granted within the 61-day proscribed period. Priv. Ltr. Rul. 6908080140A (Aug. 8, 1969). Compare this to the treatment of options, in which both the grant and the exercise of the option is each an acquisition event. It is not clear how other equity-based awards, like stock appreciation rights and phantom shares, would be treated.

6 Note that employees may be more motivated to sell shares at a loss at year-end, in order to offset gains from that year, and thus employers may want to consider avoiding January in establishing a fixed grant date or schedule because of the 30-day look-back in the wash sale rules.

7 It is unlikely that, within the 30-day period prior to the consummation of a pending acquisition, the employee would have acquired shares, although for obvious reasons it generally makes sense to educate employees about the mechanics of the wash sale rules to avoid any inadvertent triggering of the prohibition of the loss deduction.

8 Reg. Sec. 1.1233-1(d)(1).

9 S.H. Knox, 33 BTA 972 (Jan. 24, 1936).

10 M.E. Kidder, 30 BTA 59 (Mar. 13, 1934).

11 Rev. Rul. 77-201, 1977-1 C.B. 250; GCM 37004 (Feb. 15, 1977).

12 As a result of a 1988 amendment to Section 1091 of the Code, contracts and options to acquire stock or securities are themselves considered securities, and thus are relevant to application of the wash sale rules both as securities that are acquired and as securities that may be sold at a loss.

13 GCM 38285 (Feb. 22, 1980), addressing specifically exchange traded call options and declining to consider the effect, if any, of an option with a different term.