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New Twists on an Old Plot: Investors Look to Avoid the Wash Sale Rule by Harvesting Tax Losses with Exchange-Traded Funds

Garrett M. Fischer
Washington University School of Law

NEW TWISTS ON AN OLD PLOT: INVESTORS LOOK TO AVOID THE WASH SALE RULE BY HARVESTING TAX LOSSES WITH EXCHANGE-TRADED FUNDS

On October 7, 2007, all seemed well on Wall Street as the Dow Jones Industrial Average (DJIA) set a "record high," closing at 14,164.[1] But, as expressed by Sir Isaac Newton, "what goes up must come down."[2] And the U.S. stock markets came plummeting down at record pace,[3] declining by over fifty percent[4] "for the second time this decade."[5] As a result, the decline of the DJIA alone led to $11.2 trillion of investment losses between October 2007 and March 2009,[6] contributing to over $2 trillion of losses in U.S. "retirement savings."[7] As multiple financial institutions failed[8] and "credit markets froze,"[9] investors "fear[ed] another Great Depression."[10]

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1. Tim Paradis, *The Great Recession: The Numbers Tell the Story*, ABCNEWS.COM, Oct. 10, 2009, http://abcnews.go.com/print?id=8799061.

2. Mark Troutman, *What Goes Up Must Come Down*, CONTINGENCIES, Sept.–Oct. 2005, at 39, *available at* http://www.contingencies.org/sepoct05/Reinsurance_0905.pdf.

3. Investors in 2008 experienced three of the "[ten] worst percentage drops" and six of the "[ten] worst [daily] point drops in the . . . history of the Dow" Jones Industrial Average, including the largest single-day decline of 777 points on Sept. 29, 2008. Paradis, *supra* note 1.

4. The value of the DJIA declined from its record-high closing point on October 7, 2007, of 14,164.53, to its lowest closing value in twelve years on March 9, 2009, of 6,547.05. *See Historical Prices for Dow Jones Industrial Average (^DJI)*, YAHOO! FIN., http://finance.yahoo.com/q/hp?s=%5EDJI&a=09&b=3&c=2007&d=02&e=10&f=2009&g=d&z=66&y=330 (last visited Aug. 17, 2010); *see also* Paradis, *supra* note 1.

5. Adam Shell, *Stock Market Losses Take a Personal Toll on Investors*, USA TODAY, Mar. 24, 2009, at B1, *available at* http://www.usatoday.com/money/markets/2009-03-23-investor-pain_ N.htm.

6. Paradis, *supra* note 1; *see also* Elroy Dimson et al., *Keeping Faith with Stocks*, *in* CREDIT SUISSE GLOBAL INVESTMENT RETURNS YEARBOOK 2009, at 4, 5 (2009), *available at* http://emagazine.credit-suisse.com/app/_customtags/download_tracker.cfm?logged=true&dom=emagazine.credit-suisse.com&doc=/data/_product_documents/_shop/254094/research_institute_yearbook.pdf (reporting Credit Suisse's findings that between the peak of the MSCI World Index in October 2007 and the trough in November 2008, "the MSCI World index [fell] 55%—a global loss of over USD 21 trillion, or USD 21,000 for every man, woman and child in the developed world.").

7. Emily Brandon, *Retirement Savers Lost $2 Trillion in the Stock Market*, U.S. NEWS & WORLD REP., Oct. 8, 2008, http://www.usnews.com/money/blogs/planning-to-retire/2008/10/08/retirement-savers-lost-2-trillion-in-the-stock-market.html (reporting on the fifteen months preceding October 2008).

8. In mid-March 2008, the investment bank Bear Stearns collapsed; in September of the same year, Fannie Mae, Freddie Mac, Lehman Brothers, and AIG fell within ten days of each other. *See* Paradis, *supra* note 1.

9. *Id.*

10. *Id.*

Investors have traditionally been able to capitalize on long-term increases in the value of stocks[11] by utilizing the simple strategy of "buying low and selling high."[12] However, now that the United States is "facing one of the largest financial crises in history,"[13] investors may look to maximize their returns through more creative investment strategies. Accordingly, this Note will analyze the proper taxation with respect to the Wash Sale Rule (26 U.S.C. § 1091)[14] for investors who creatively use contemporary investment mechanisms, known as exchange-traded funds (ETFs),[15] to minimize the effects of capital losses[16] through a process known as tax loss harvesting.[17]

Part I of this Note will provide an introductory explanation of tax loss harvesting, followed by an introductory explanation of the Wash Sale Rule in Part II. Then, in Parts III and IV, respectively, this Note will provide an explanation of ETFs and their history. In Part V, this Note will provide an in-depth discussion of the statutory language and administrability of the Wash Sale Rule. Finally, Part VI of this Note will provide an explanation as to why a proper analysis of ETFs under the Wash Sale Rule should entail a look at the underlying holdings of each ETF to determine if the funds are economically similar.

I. INTRODUCTION TO TAX LOSS HARVESTING

One method of "making lemonade out of . . . stock market lemons"[18] is to take full advantage of tax strategies provided in the U.S. Tax Code (the Code).[19] It seems ironic that taxpayers would look to the tax system to provide relief from their capital losses when so many feel that the tax

11. *See* Jeremy J. Siegel & Jeremy D. Schwartz, *Long-Term Returns on the Original S&P 500 Companies*, 62 FIN. ANALYSTS J. 18, 21 (2006) (stating that "[f]rom [its inception on] 1 March 1957 through 31 December 2003, the S&P 500 registered a 10.85 percent annualized compound return").

12. Chuck Saletta, *How to Buy Low and Sell High*, THE MOTLEY FOOL (Feb. 22, 2006), http://www.fool.com/investing/value/2006/02/22/how-to-buy-low-and-sell-high.aspx.

13. President Barack Obama, Address at Federal Hall on the Financial Crisis (Sept. 14, 2009) (text of prepared speech available at http://whitehouse.blogs.foxnews.com/2009/09/14/obamas-remarks-on-the-financial-crisis-as-prepared-for-delivery/) (transcript available from the Government Printing Office).

14. See *infra* note 49 for the statutory language of 26 U.S.C. § 1091.

15. See *infra* notes 59–64 and accompanying text for a brief definition of exchange-traded funds.

16. See *infra* note 22 for a definition of a loss of capital assets (also known as a capital loss).

17. See *infra* Part I for a discussion of tax loss harvesting.

18. *Loss Harvesting*, ACCUMULATING MONEY (Sept. 3, 2009), http://www.accumulatingmoney.com/loss-harvesting/.

19. *See* James Quackenbush, Commentary, *It's Time to Consider Tax Loss Selling*, THE DAILY REC. OF ROCHESTER, Dec. 10, 2008, http://nydailyrecord.com/blog/2008/12/10it8217s-time-to-consider-tax-loss-selling/.

system is a mere hindrance to their economic positions;[20] however, Congress's general policy to only tax gain or enrichment[21] compels the Internal Revenue Service (IRS) to provide favorable tax treatment for losses on capital assets.[22] In turn, a taxpayer, other than a corporation, may subtract his capital losses from the capital gains he realized[23] during the taxable year,[24] consequently reducing the amount of taxes owed. If the capital losses exceed the capital gains, the taxpayer may further deduct the excess losses or $3,000, whichever is less.[25] And if, after taking the allowed deduction, the taxpayer still has remaining capital losses, he may carry those losses forward to future years.[26] With capital losses reaching

20. Representative Ron Paul has stated that "ideally, [he would] get rid of the income tax." Maria Bartiromo, *Ron Paul on the Evil Fed, the IRS, and Saving the Buck*, BUSINESSWEEK, Nov. 29, 2007, *available at* http://www.businessweek.com/magazine/content/07_50/b4062021769214.htm. Rep. Paul has further proposed a bill to not tax the tips that employees receive while "waiting on tables" or performing similar services, and he proposes that people in college should not be taxed at all because it "make[s] it hard for them." *Id.*

21. The Sixteenth Amendment provides that "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI. The Supreme Court historically defined income as "*gain* derived from capital, from labor, or from both combined," and provided that the definition would "include profit gained through a sale or conversion of capital assets." Eisner v. Macomber, 252 U.S. 189, 207 (1920) (emphasis added).

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

26 U.S.C. § 1001(a) (2006). See *infra* note 170 for an explanation of adjusted basis.

22. Before discussing the tax treatment of capital losses, it is important to understand what Congress had in mind when it used the term "capital asset." As Congress explained and later codified in Title 26 of the United States Code,

> [a] capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.

H.R. REP. NO. 109-304, at 46 (2005);*see also* 26 U.S.C. § 1221(a) (2006) (codifying the eight exceptions set forth above).

23. The amount of gains "realized" for a year include the "sum of any money received plus the fair market value of the property (other than money) received." 26 U.S.C. § 1001(b).

24. *See* 26 U.S.C. § 1211(b) (2006); *see also Time to Harvest 2008 Tax Losses*, VANGUARD (2009), https://retirementplans.vanguard.com/VGApp/pe/pubnews/HarvestTaxLosses.jsf?SelectedSegment=ThinkingaboutRetirement.

25. *See* 26 U.S.C. § 1211 (b).

26. *See* 26 U.S.C. § 1212(b) (2006); *see also* James Quackenbush, Commentary, *It's Time for Year-End Tax Planning*, THE DAILY REC. OF ROCHESTER, DEC. 10, 2009, http://nydailyrecord.com/blog/2009/12/09/it8217s-time-for-yearend-tax-planning/ (suggesting that carrying forward large tax losses from 2008 and 2009 into future tax years could be "extremely beneficial," considering that "it

far into the trillions of dollars for 2008,[27] these deductions can be tremendously valuable in offsetting current or future capital gains.[28]

The significance of these deductions is further enhanced by the fundamental structure of the U.S. tax system, which provides that "investment gains and losses are not recognized until the investment is sold."[29] Thus, by controlling when they sell the investment, taxpayers have the ability to determine at what time they are taxed.[30] When the allowed deduction for capital losses is combined with the ability to control when one is taxed, an incentive is created to ignore the traditional adage of "buy low and sell high"[31] and, instead, sell low and look to use capital losses to offset current or future capital gains.

This incentive is what lies behind the process commonly known as tax loss harvesting.[32] Tax loss harvesting is "the process of selling securities at a loss from their original cost, . . . creating a capital loss, which is then used to offset other capital gains produced throughout the year, as well as future gains."[33] Thus, consider an investor who purchased 1000 shares of Corporation X for $30,000, the value of which has declined to $20,000. The investor could consider selling his position in Corporation X in order to harvest his losses. Essentially, the $10,000 tax loss realized could be used to "offset other capital gains that may have been produced through the year."[34] So, if the investor has $2000 of total capital gains for the year from other investments, his $10,000 capital loss would reduce his tax liability for the capital gains to zero, and the remaining $8000 loss could be used to offset future capital gains.[35]

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has been rumored" that the Obama administration may increase the rates for the long-term capital gains tax); *Time to Harvest*, *supra* note 24.

27. *See* Paradis, *supra* note 1; *see also* Brandon, *supra* note 7.

28. *See supra* text accompanying notes 23–26.

29. David M. Schizer, *Financial Instruments: Special Rules*, [2010] 1 Tax Mgmt. (BNA) 186, at § 1-A; *see also* 26 U.S.C. §§ 61(a)(3), 1001(a) (2006) (codifying that a security must be "derived" through "sale or other disposition of property" before gain or loss can be realized); Eisner v. Macomber, 252 U.S. at 213 (1920) (stating that in the case of stock dividends, "without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock," and "to tax a stock dividend is to tax a capital increase, and not income").

30. *See* Schizer, *supra* note 29.

31. Saletta, *supra* note 12 (referring to tax loss harvesting as "tax loss selling"); *see also* Richard Shaw, *Tax Loss Harvesting & the 'Wash Sale' Rule*, SEEKING ALPHA, Aug. 16, 2007, http://seekingalpha.com/article/44749-tax-loss-harvesting-the-wash-sale-rule (referring to the process as "tax loss harvesting").

32. *See* Quackenbush, *supra* note 19.

33. *Id.*

34. *Id.*; *see also Time to Harvest*, *supra* note 24.

35. *See* Quackenbush, *supra* note 19; *see also Time to Harvest*, *supra* note 24.

When investors sell their securities for losses, they not only have the opportunity to offset capital gains, but they also liberate cash—previously tied up in the investment—that can subsequently be reinvested.[36] Investors will particularly want to reinvest their capital if they believe that the market has reached its financial "bottom"[37] because they will expect a "steady increase"[38] in the price in the near future. Expectations of upward trends following significant decreases in the market are not without justification, with the Standard & Poor's (S&P) 500 Index[39] increasing by an average of 21.36% within six months, following the past seven bear-market bottoms.[40] More specifically, the DJIA has increased by 49.29% since its lowest position on March 9, 2009,[41] while the S&P 500 has increased by 52.35%.[42]

Therefore, considering the fact that investors have the ability to choose when their tax gains or losses are to be realized through a sale or disposition of the security[43]—as well as the fact that financial markets often increase substantially following a financial bottom[44]—it is logical to conclude that an investor will try to maximize his investment returns by attempting to sell his securities at the lowest point in order to offset the largest amount of capital gains, before immediately repurchasing that same security so that he may benefit from the upward trend that will likely

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36. Margaret Hwang Smith & Gary Smith, *Harvesting Capital Gains and Losses*, 17 FIN. SERVS. REV. 309, 312 (2008).

37. The "bottom" is "[t]he lowest point or price reached by a financial security, commodity, index or economic cycle in a given time period, which is followed by a steady increase." *Bottom*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/b/bottom.asp (last visited Aug. 17, 2010).

38. *Id.*

39. "The S&P 500 [Index] has been widely regarded as the best single gauge of the large cap U.S. equities market . . . includ[ing] 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities." *S&P 500*, STANDARD & POOR'S, http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l-- (last visited Aug. 17, 2010).

40. Percentage increases in the S&P 500 six months after a bear-market bottom were as follows: 17.2% (June 1949), 8.1% (Oct. 1957), 29.3% (June 1970), 25.2% (Sept. 1974), 39.1% (July 1982), 25.4% (Oct. 1990), and 5.2% (Sept. 2002). Paul Price, *Economic Recoveries and Stock Market Rebounds: What Does the Historical Data Show?*, SEEKING ALPHA, Oct. 9, 2009, http://seekingalpha.com/article/165665-economic-recoveries-and-stock-market-rebounds-what-does-the-historical-data-show (citing data gathered by Montgomery Brothers, Cappiello, LLC).

41. Results are reported as of the end of Quarter 2 of 2010, with the DJIA increasing from its closing value of 6,547.05 on March 9, 2009, to its closing value on June 30, 2010, of 9,774.02. *Historical Prices for Dow Jones Industrial Average (^DJI)*, *supra* note 4.

42. Results are reported as of the end of Quarter 2 of 2010, with the S&P 500 index increasing from its closing value of 676.53 on March 9, 2009, to its closing value on June 30, 2010, of 1,030.71. *Historical Prices for S&P 500 Index, RTH (^GSPC)*, YAHOO! FIN., http://finance.yahoo.com/q/hp?s=%5EGSPC&a=02&b=9&c=2009&d=05&e=30&f=2010&g=d&z=66&y=0 (last visited Aug. 25, 2010).

43. *See* Schizer, *supra* note 29.

44. *See supra* note 40 and accompanying text.

follow. Following this procedure, the investor could enjoy the deduction of capital losses against his future capital gains, without ever losing his economic position in the security.[45]

II. INTRODUCTION TO THE WASH SALE RULE

Although the tax laws can be generous toward investment returns in some instances,[46] Congress sought to prevent an investor from harvesting his tax losses while also maintaining the same economic position.[47] This is to say that Congress does not want an investor to be able to sell a security for a capital loss, deduct that loss against his capital gains, and then immediately repurchase the same security in order to benefit from future increases in price.[48] Accordingly, Congress, in 1954, placed restrictions on an investor's ability to maintain the same economic position under these circumstances, passing what is currently codified at 26 U.S.C. § 1091(a).[49] Commonly known as the "Wash Sale Rule," § 1091 prevents an individual investor[50] from deducting any loss that was sustained from the sale of a stock or other security if the investor purchases "substantially identical

45. *See* Schizer, *supra* note 29.

46. *See, e.g.*, Rande Spiegelman, *Municipal Bonds: When "Tax-Free" Isn't So Free*, CHARLES SCHWAB (Jan. 11, 2006), http://www.schwab.com/public/schwab/research_strategies/market_insight/investing_strategies/bonds/municipal_bonds_when_tax_free_isnt_so_free.html ("Municipal bonds have long been an attractive investment option for tax-sensitive investors, because munis are free of federal income tax [on interest of the municipal bond] and often state tax too."); *see also* 26 U.S.C. § 103(a) (2006).

47. The "purpose of the wash sales provisions is to prevent tax manipulation by a taxpayer who attempts to recognize a loss on the sale of 'securities' while maintaining an identical or nearly identical investment position." I.R.S. Gen. Couns. Mem. 38,369 (May 9, 1980).

48. *See id.*

49. To prevent taxpayers from taking deductions for capital loses while maintaining the same economic position in the market, Congress set forth the following in 26 U.S.C. § 1091(a):

> [i]n the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business . . . .

26 U.S.C. § 1091(a) (2006).

50. The regulations interpreting § 1091 distinguish an individual taxpayer from a corporate taxpayer and provide an exception to § 1091 for individual taxpayers "if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business." 26 C.F.R. § 1.1091-1(a) (2010). This exception is also provided for a corporation if it is a "dealer in stock or securities" and the "sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer." *Id.*

stock or securities"[51] within thirty days before or after the date of the sale.[52]

It would appear that Congress solved the problem of an investor attempting to use the tax laws to harvest his losses, while also maintaining the same economic position in "substantially identical stock or securities."[53] However, neither Congress, nor the Treasury, nor the IRS[54] has sought to define either "substantially identical"[55] or "stock or securities,"[56] which inevitably leads to ambiguity and fails to provide investors with a clear rule on which to base their tax planning efforts. Because shares of a given corporation would undoubtedly be substantially identical to shares of the same corporation, it seems relatively clear that an investor may not purchase a share of Corporation Y, sell Corporation Y for a capital loss, use that loss to offset his capital gains, and then repurchase a share of Corporation Y within thirty days in order to maintain his economic position.[57] Yet, as the financial vehicles available to investors for use in tax harvesting continue to become inherently more complex,[58] harvesting transactions often lack the clarity available in this simple example of buying and selling stock of Corporation Y.

III. EXPLANATION OF EXCHANGE-TRADED FUNDS

An ETF is one example of a complex investment vehicle that has "presented investors with new twists on an old plot, [specifically,] how to

51. 26 U.S.C. § 1091 (2006).

52. *See id.*

53. *See id.*

54. It is important to understand how Congress, the IRS, and the Treasury Department influence tax policy. "The Internal Revenue Code [set forth in Title 26 of the U.S. Code] is law. It was passed by the United States Congress. It does not come from the IRS. The IRS writes regulations that help implement the Code, but the Code itself was passed by Congress." *Income Tax Myths: "The Internal Revenue Code is Not Law,"* GEO. WASH. UNIV., http://docs.law.gwu.edu/facweb/jsiegel/Personal/taxes/code.htm (last visited Aug. 17, 2010). At the same time, the Department of the Treasury issues regulations, set forth in Title 26 of the Code of Federal Regulations, that are intended to interpret the provisions of the Internal Revenue Code set forth by Congress. *Treasury Regulations*, CORNELL UNIV. L. SCH. LEGAL INFO. INST., http://topics.law.cornell.edu/wex/treasury_regulations (last visited Aug. 17, 2010).

55. In a 2007 interview, Mr. Robert Willens, CPA, indicated that "'substantially identical' has never been fully defined—that it is one of those things that perhaps you can't define, but you know it when you see it." Shaw, *supra* note 31. Mr. Willens is the former managing director at Lehman Brothers and "former[] tax partner-in-charge of the capital markets group at KPMG Peat Marwick and . . . a prolific author on tax matters." *Id.*

56. "Section 1091 applies to losses from the sale of 'stock or securities,' although neither term is defined in §1091." *See* Schizer, *supra* note 29, at A-1, A-9.

57. *See id.*

58. See *infra* Part III for a discussion of exchange-traded funds and mutual funds.

take advantage of loopholes in the wash-sale rule without running afoul of it."[59] Registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940[60] as "open-end[] funds"[61] or "unit investment trusts,"[62] ETFs allow investors to enjoy a diversified investment through the "array of underlying securities" that comprise each ETF.[63] In turn, the underlying securities of each ETF will be indexed to specific "benchmarks—such as the S&P 500 Composite Price Index."[64]

In terms of providing diversity, ETFs are similar to traditional[65] mutual funds,[66] with both investment funds "provid[ing] an investor with access to an array of underlying securities through a single investment."[67] There are some key distinctions, however, between these two types of investment funds that are important to the issue of taxation at hand. First, ETF shares[68] are traded on stock exchanges, just like shares of an individual corporation, with the price of the ETF shares constantly

59. A. Seddik Meziani & James G.S. Yang, *Use Exchange-Traded Funds to Harvest Tax Losses*, 74 PRAC. TAX STRATEGIES 272, 272 (2005). Furthermore, the phrase "new twists on an old plot" that was used in this Article and quoted in the text accompanying this footnote served as the inspiration for the title of this Note.

60. 15 U.S.C. § 80a (2006).

61. An open-end fund is "[a] fund operated by an investment company which raises money from shareholders and invests in a group of assets, in accordance with a stated set of objectives." *Open-End Fund*, INVESTORWORDS.COM, http://www.investorwords.com/3436/open_end_fund.html (last visited Aug. 17, 2010); *cf. Closed-End Fund*, INVESTORWORDS.COM, http://www.investorwords.com/893/closed_end_fund.html (last visited Aug. 17, 2010) (stating that "closed-end funds issue a fixed number of shares to the public in an initial public offering, after which time shares in the fund are bought and sold on a stock exchange, and they are not obligated to issue new shares or redeem outstanding shares as open-end funds are").

62. A unit investment trust is "[a]n SEC-registered investment company which purchases a fixed, unmanaged portfolio of income-producing securities and then sells shares in the trust to investors." *Unit Investment Trust*, INVESTORWORDS.COM, http://www.investorwords.com/5161/Unit_Investment_Trust.html (last visited Aug. 17, 2010).

63. William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 72 (2008).

64. *Id.*; *see also Standard & Poor's Depositary Receipts*, YAHOO! FIN., http://finance.yahoo.com/q?s=SPY (last visited Aug. 17, 2010) (tracking the price movements of the S&P 500 index).

65. Mutual funds have been around since the 1920s, with "America's first mutual fund," MFS Massachusetts Investors Trust, starting in 1924. Charles E. Rounds, Jr., *State Common Law Aspects of the Global Unwindings of the Madoff Ponzi Scheme and the Sub-Prime Mortgage Securitization Debacle: Buttressing the Thesis that Globalizing the American Law School Curriculum at the Expense of Instruction in Core Common Law Doctrine Will Only Further Provincialize It*, 27 WIS. INT'L L.J. 99, 108 (2009). State Street Research Investment Fund was also started in 1924. *Id.*

66. A mutual fund is an "open-end company," which "pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, or other securities." *Mutual Funds*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/mutfund.htm (last visited Aug. 17, 2010). See *supra* note 61 for the definition of an open-end fund.

67. *See* Birdthistle, *supra* note 63, at 72.

68. "ETF shares" refers to the shares purchased by individual investors of the exchange-traded fund itself, which is to be distinguished from the underlying securities of the fund.

adjusting to meet market expectations.[69] In comparison, mutual funds are priced only at the close of each business day,[70] based upon calculations of the net asset value (NAV)[71] of the fund. Thus, an investor can trade ETFs throughout the day based on the supply and demand of the market,[72] whereas a mutual fund owner can only "place a sell order and . . . [wait] until closing bell."[73]

Another key distinction between ETFs and mutual funds involves the management of the funds. As stated previously, ETFs are benchmarked to specific indexes,[74] maintaining an "ironbound connection to the index,"[75] regardless of "how specialized its index may be."[76] Consequently, the "price of the [ETF] shares at any given moment fairly equals the price of all the underlying securities in the fund's portfolio,"[77] and the fund must

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69. *See* Birdthistle, *supra* note 63, at 69, 71.

70. *Id.* at 77.

71. The price of a mutual fund is based on the net asset value (NAV), which is calculated by multiplying the number of shares of each of the securities [the fund] owns by the respective closing prices of those shares. That aggregate product of the portfolio is then added to any cash or other assets owned by the fund, while liabilities—such as fees owed to the advisor or other service providers—are subtracted. The resulting sum is then divided by the total number of shares issued by the mutual fund.

Id.

72. Throughout the trading day, "the price at which investors buy and sell ETF shares may not necessarily equal the NAV of the portfolio of securities in the ETF." As a result, if "two investors sell[] the same ETF shares at different times on the same day[,] [they] may receive different prices for their shares"; it is possible that both of these prices may be different than the ETF's NAV. INVESTMENT COMPANY INSTITUTE, 2009 INVESTMENT COMPANY FACT BOOK 43 (49th ed. 2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf.

73. Birdthistle, *supra* note 63, at 78.

74. *Id.* at 72.

75. *Id.* at 82. In 2008, the SEC "granted exemptive relief" to some fund sponsors so that they could offer "fully transparent actively managed ETFs," as long as they met certain requirements. Among other obligations, these fund sponsors "must disclose each business day on their publicly available websites the identities and weightings of the component securities and other assets held by the ETF." INVESTMENT COMPANY INSTITUTE, *supra* note 72, at 40. Rather than tracking the performance of a particular index, "an actively managed ETF's investment adviser, like that of an actively managed mutual fund, creates a unique mix of investments to meet a particular investment objective and policy." *Id.* For the purposes of this discussion, however, the term "ETF" will refer only to index-based ETFs that are designed exclusively to track a specified index. For reasons discussed later, an actively managed ETF or actively managed mutual fund does not present the same tax problems with respect to 26 U.S.C. § 1091(a) as presented by index-based ETFs, and conclusions reached for actively managed mutual funds should be equally applicable to actively managed ETFs.

76. Birdthistle, *supra* note 63, at 82.

77. *Id.* at 72.

> A key component of . . . ETFs is transparency. . . . The composition of the ETF must be known publicly. . . . Only by comparing ETF shares to the corresponding prices of the underlying portfolio securities that the ETF holds can one ascertain whether the ETF shares are [properly] priced. . . . Every potential investor [in an ETF] knows that the ETF is attempting to replicate the performance and price of the [given index] and can evaluate the performance of the ETF on those terms.

"necessarily ride the financial difficulties [or advantages] down [or up] in value,"[78] as reflected by the benchmarked index. On the other hand, "[m]utual funds can have actively managed portfolios, in which a professional investment adviser creates a unique mix of investments to meet a particular investment objective; or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index."[79]

IV. HISTORY OF THE GROWTH OF EXCHANGE-TRADED FUNDS

When the human element enters the investment equation, as it does with mutual funds,[80] the possibility exists that greed may tempt fund managers to act outside of the securities regulations set forth for mutual funds.[81] Accordingly, it was not surprising when New York Attorney General Elliott Spitzer initiated an investigation in 2003 to examine "possible illegal market timing of mutual funds."[82] This investigation had a significant impact on the investment community. As a result of the investigation, new SEC regulations were drafted to address the "widespread malfeasance,"[83] and investors lost confidence in mutual

Id. at 81. However, it is important to point out that the underlying securities of an ETF may not fully replicate that of the benchmark index. *Id.* at 79. The reason is that a fund sponsor might decide to track the index through use of "a representative sample of the securities in that index . . . [if the fund] might more efficiently attain its goals by trafficking in just that subset of securities." *Id.* at 79–80.

78. *Id.* at 82.

79. INVESTMENT COMPANY INSTITUTE, *supra* note 72, at 172.

80. *Id.*

81. It was once stated that "[o]ur basic human emotions are also part of our evolutionary makeup: when we want to possess more, it is greed; when we want to protect more, it is fear." Richard S. Whitt, *Adaptive Policymaking: Evolving and Applying Emergent Solutions for U.S. Communications Policy*, 61 FED. COMM. L.J. 483, 505 (2009).

82. Birdthistle, *supra* note 63, at 99. The "most well-known" market timing allegations included using differences in time zones for purposes of arbitrage. *Id.* at 100–01. For example, if a mutual fund in the United States held stocks that were traded on the Tokyo Stock Exchange (TSE), differences in time zones would lead to the Japanese stocks being traded at different times of the day than stocks on the New York Stock Exchange (NYSE). *Id.* at 101. "Because mutual funds are priced just once a day, typically at the close of the New York stock markets at 4:00 p.m. eastern time," the fund may use the closing price for the TSE when calculating its NAV, even though there may have been "negative financial news" for those companies. *Id.* at 100–01. As a result, the NAV price may be too high "until the shares are priced again the next day using fresh prices from the TSE." *Id.* at 101. This allowed hedge funds and other investors "to move large amounts of cash in and out of mutual funds quickly to profit through this time zone arbitrage." *Id.*; *see also id.* at 100 n.150 (citing John Kimelman, *Fresh Pricing Is a Draw for Exchange-Traded Funds*, N.Y. TIMES, Nov. 9, 2003, at 6) ("Several investigations into mutual fund trading practices are continuing, and Congress and the Securities and Exchange Commission are considering ways to change the industry's practices. Because of their constant repricing, exchange-traded funds, which track stock and bond indexes, have been conspicuously immune to these problems.").

83. Birdthistle, *supra* note 63, at 100.

funds.[84] With mutual funds being thought of as "tainted investment products,"[85] investors fled from mutual funds and looked to ETFs for their "perceived safety."[86] This transition led to a "rapid acceleration in the growth rate of ETFs,"[87] which had previously experienced a steady, but slow, increase to 120 funds and $150 billion in assets since the first ETF was created in 1993.[88]

The first ETF to be created was "known as Standard & Poor's Depository Receipts (SPDRs, pronounced 'spiders')."[89] Through its initial 150,000 shares traded on the American Stock Exchange,[90] SPDRs represented "an investment trust which, in turn, held a portfolio of shares of common stock in all the companies in the S&P 500, in substantially the same proportion as the index."[91] Thus, SPDRs was able to effectively capture the idea of investing in the entire index by purchasing a "single share" of the ETF.[92]

As more and more investors look to incorporate ETFs into their investment strategies, these funds continue to show strong signs of growth.[93] For example, "over the period of 2000 to 2008, there were 758 ETFs created, with the majority being offered in the last three years."[94] Furthermore, this increase in funds has led to a net increase of $661 billion in new ETF shares between 1998 and 2008.[95] In 2008 alone, there were 149 ETFs created and 50 liquidated, bringing the total number of ETFs to 728 at year end.[96] "By many accounts, the flow of assets into ETFs is

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84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.* at 99.
89. *Id.* at 76.
90. SPDRs is now recognized as the SPDR S&P 500 ETF, which represents the SPDR Trust Series 1, and trades under the ticker symbol SPY. *ETFs SPY Overview*, AMEX, http://www.amex.com/etf/prodInf/EtPiOverview.jsp?Product_Symbol=SPY (last visited Aug. 17, 2010). The fund continues to "seek investment results that . . . generally correspond to the price and yield performance of the Standard & Poor's 500 Composite Stock Price Index." *Id.* As of March 30, 2010, there were 684,832,000 shares of SPY outstanding, demonstrating significant growth since 1993. *Id.*
91. *See* Birdthistle, *supra* note 63, at 76–77.
92. *Id.* at 77.
93. *See generally* INVESTMENT COMPANY INSTITUTE, *supra* note 72, at 46–47. Also, consider that, in 2008, global and international ETFs issued $25 billion of new shares, whereas "mutual funds that invested in foreign markets experienced substantial outflows in 2008." *Id.*
94. *Id.* at 47.
95. *Id.* at 46. Note that "ETFs that track large cap domestic equity indexes, such as the S&P 500, managed $185 billion or 35 percent of all assets invested in ETFs." *Id.*
96. *Id.* at 47. The total number of ETFs at year end from 2000 to 2008 are as follows: 80 (2000), 102 (2001), 113 (2002), 119 (2003), 152 (2004), 204 (2005), 359 (2006), 629 (2007), and 728 (2008). *Id.*

projected to continue rising—to more than $2 trillion—in the next few years."[97]

V. DISCUSSION OF SECTION 1091

It is clear from the discussion above that ETFs have significantly grown in popularity, becoming an important part of many investors' portfolios.[98] Priced moment to moment to reflect the price of the underlying securities,[99] it was also explained above that ETFs can be traded on stock markets throughout the day, based on supply and demand, like any other equity security.[100] Because of the relative ease of trading ETF shares, investors could easily harvest their losses by purchasing or selling ETFs in conjunction with similar stocks,[101] mutual funds,[102] or other ETFs.[103] The objective of these transactions would, of course, be to sell one security (stock, mutual fund, or ETF) and simultaneously purchase an ETF that would similarly maintain the investor's position in

97. *See* Birdthistle, *supra* note 63, at 74.

98. *See supra* notes 80–97 and accompanying text.

99. *See supra* text accompanying note 77.

100. *See supra* text accompanying note 69.

101. For example, consider an investor who has experienced losses on his shares of Bank of America Corporation (BAC), but, at the time, there is also a "buy recommendation" on BAC by analysts, indicating the stock price is likely to rise. *See generally* Meziani, *supra* note 59, at 275. That investor could sell his shares of BAC for a loss and simultaneously purchase shares of an ETF such as Financial Select Sector SPDR (XLF), of which 10.12% consists of BAC stock. *Holdings for Financial Select SPDR (XLF)*, YAHOO! FIN., http://finance.yahoo.com/q/hl?s=XLF (last visited Aug. 17, 2010); *see also* Meziani, *supra* note 59, at 278. This allows the investor to enjoy the tax benefits of the loss on BAC, while still providing him exposure to BAC and to the entire financial sector. *See id.*

102. For example, an investor may sell his stake in the Vanguard 500 Index Fund (VFINX), which "employs a passive management investment approach designed to track the performance of the Standard & Poor's 500 index," and then the investor may immediately purchase an equal equity stake in SPDR S&P 500 ETF (SPY), which is an ETF that also tracks the S&P 500 index. *Vanguard 500 Index Investor (VFINX)*, YAHOO! FIN., http://finance.yahoo.com/q?s=VFINX (last visited Aug. 17, 2010). *See* Meziani, *supra* note 59, at 276; *see also supra* note 90 (discussing SPY). This exchange allows the investor to realize his tax losses, while, at the same time, maintaining his broad exposure in the S&P 500 index. *See* Meziani, *supra* note 59, at 276.

103. For example, an investor may sell his losing shares of the Vanguard Emerging Market ETF (VWO), an ETF that "seeks to track the performance of the MSCI Emerging Markets index," in order to realize a capital loss. *Vanguard Emerging Markets stock ETF (VWO)*, YAHOO! FIN., http://finance.yahoo.com/q?s=vwo (last visited Aug. 17, 2010). Then, the investor may immediately purchase shares of iShares MSCI Emerging Markets Index (EEM), which also "seeks investment results that correspond generally to the price and yield performance of the MSCI Emerging Markets index." *iShares MSCI Emerging Markets Index (EEM)*, YAHOO! FIN., http://finance.yahoo.com/q?s=eem (last visited Aug. 17, 2010). Essentially, despite the two ETFs being sold by separate companies, they are set up to track the same index. *See* Meziani, *supra* note 59, at 276–77. By selling one of these ETFs and purchasing the other, the investor would be able to maintain his position in the market. *See id.*

the market.[104] However, despite the opportunity to maintain the investor's position in the market, to which Congress has demonstrated its opposition in § 1091,[105] "legal scholars have virtually ignored ETFs"[106] with respect to the Wash Sale Rule.

By failing to define "substantially identical stock or securities"[107] in § 1091, Congress, the Treasury, and the IRS have left many questions unanswered regarding the tax liability of an investor who uses ETFs to harvest his capital losses. For instance, can an investor realize his capital losses by selling his stock in a company for a loss, and then buying an ETF within thirty days that contains that stock as one of its underlying securities?[108] Can an investor sell, for a loss, a mutual fund that tracks a specific index and then purchase an ETF that tracks the same index within a thirty-day period and still recognize the loss?[109] Can an investor sell an ETF that tracks a particular index for a loss and then purchase an ETF from a different company that tracks the same index within the thirty-day period and still recognize the loss?[110] The forthcoming discussion[111] and subsequent analysis[112] will address each of these questions.

A. Statutory Construction

Before such specific questions can be addressed, however, one's quest to fully understand the tax implications of the Wash Sale Rule with respect to ETFs must begin with an understanding of how the phrase "substantially identical stock or securities"[113] in § 1091 relates to ETFs. To gain this understanding, two questions must be addressed. First, is an ETF a "stock or security"?[114] And, second, how closely related must the ETF be to another security to be considered "substantially identical"?[115]

104. For purposes of this discussion, the transactions at issue will be those where a stock, mutual fund, or ETF is sold for a loss, and an ETF is purchased by the investor within thirty days of the sale. It is worthy to note that the investor could just as easily sell an ETF for a loss and then purchase a stock or mutual fund; however, the author believes that the conclusions reached from this discussion would be the same with respect to other variations of these transactions, and, for that reason, the discussion remains more narrowly focused.

105. *See* 26 U.S.C. § 1091(a) (2006).

106. *See* Birdthistle, *supra* note 63, at 69.

107. *See supra* notes 55–56.

108. *See infra* Part VI.A.

109. *See infra* Part VI.B.

110. *See infra* Part VI.C.

111. *See infra* Part V.A–B.

112. *See infra* Part VI.

113. *See* 26 U.S.C. § 1091(a) (2006).

114. *See infra* Part V.A.1 (defining "stock or securities").

115. *See infra* Part V.A.2 (defining "substantially identical").

1. Defining "Stock or Securities"

While § 1091 and the Treasury Regulations thereunder fail to define "stock or securities,"[116] the IRS has provided a good starting place for understanding this phrase in its General Counsel Memorandum (GCM) 38,369.[117] In GCM 38,369, the agency addressed the issue of "whether Treasury bill futures are 'securities' for purposes of § 1091's wash sale rules."[118] While the IRS's *conclusion* in GCM 38,369 that "Treasury bill futures are 'securities' for purposes of section 1091 because they are 'rights to purchase an evidence of indebtedness'"[119] is not much help in defining whether ETFs are "securities" for purposes of § 1091, the *analysis* provided by the IRS proves to be very helpful.

In defining whether Treasury bills are "securities" for purposes of § 1091, the IRS in GCM 38,369 focused on other places in the Code where the term "securities" is used.[120] Despite the acknowledgement in GCM 38,369 that "there is no indication in the legislative history that any other definition of 'security' or 'securities' set forth in the Internal Revenue Code was specifically intended to apply for purposes of section 1091,"[121] the IRS further asserted that "one must consider any general congressional intent that may be gleaned from the Code and section 1091."[122] Thus, in searching for congressional intent, GCM 38,369 searched the Code for consistent use of the term "securities" because, "[a]s a matter of statutory interpretation, [if] Congress expressly treats an item consistently throughout many sections of the Code [it] may provide strong evidence that the item should be similarly treated for purposes of a section in which the item is not expressly addressed."[123] Accordingly, GCM 38,369 analyzed how the term "security" is defined in four other sections

116. *See supra* text accompanying notes 55–56.

117. I.R.S. Gen. Couns. Mem. 38,369 (May 9, 1980) [hereinafter GCM 38,369]. Tax practitioners will often look to General Counsel Memoranda (GCM) "[if] they are unable to find court cases that address the issue at hand." Edward J. Schnee, *The Value of an IRS General Counsel Memorandum*, J. ACCT. 62 (June 1998), *available at* http://www.allbusiness.com/accounting/680960-1.html. GCMs "generally [offer] guidance—extensively crossreferenced and updated to reflect current IRS policy—for IRS district offices to use in formulating positions. . . . They . . . appear to provide a better foundation than letter rulings for well-reasoned decisions." *Id.*

118. *See* GCM 38,369, *supra* note 117.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

of the Code: §§ 165(a)(2),[124] 1236(c),[125] 402(a)(3),[126] and 6323–6324.[127] Lacking consistency and "conflicting in their content,"[128] however, the IRS in GCM 38,369 refused to accept the statutory definitions set forth in these sections due to the simple assertion that *any* of the conflicting definitions "might reflect the intent of Congress with respect to section 1091."[129]

Instead, the IRS focused on the purpose of § 1091, which is "to prevent tax manipulation by a taxpayer who attempts to recognize a loss on the sale of 'securities' while maintaining an identical or nearly identical investment position."[130] In discussing the purpose of § 1091, GCM 38,369 cited the discussion of call options[131] in GCM 38,285,[132] in which the IRS

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124. GCM 38,369 analyzed how the term "security" is used in § 165(a)(2). *Id.* GCM 38,369 explained that for purposes of § 165, § 165(g) provides the applicable definition,

> which deals with losses from "worthless securities," as a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Id.; *see also* 26 U.S.C. § 165(g)(2) (2006).

125. IRS Code § 1236(c) defines "securities" "to mean any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." *See* GCM 38,369, *supra* note 117; *see also* 26 U.S.C. § 1236(c) (2006).

126. IRS Code § 402(a)(3) defines "securities" for the purposes of § 402(a), dealing with "the taxability of a beneficiary of an employees' trust," as "only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form." *See* GCM 38,369, *supra* note 117; *see also* 26 U.S.C. § 402(a)(3) (2006).

127. GCM 38,369 analyzed how the term "security" is used in §§ 6323–24. *See* GCM 38,369, *supra* note 117. GCM 38,369 explained that when dealing with these two sections,

> which deal with the validity of certain tax liens, section 6323(h)(4) defines the term "security" to mean any bond, debenture, note or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

See GCM 38,369, *supra* note 117; *see also* 26 U.S.C. §§ 6323–6324 (2006).

128. "Compare sections 165(g)(2) and 402(a)(3) ('securities would not encompass rights to purchase evidences of indebtedness') with sections 1083(f), 1236(c), and 6323(h)(4) ('securities' would encompass rights to purchase evidences of indebtedness)." *See* GCM 38,369, *supra* note 117; *see also* 26 U.S.C. §§ 1083(f), 1236(c), 6323(h)(4) (2006).

129. *See* GCM 38,369, *supra* note 117.

130. *Id.*

131. A call option is "[a]n agreement that gives an investor the right (but not the obligation) to buy a stock, bond, commodity, or other instrument at a specified price within a specific time period." *Call Option*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/c/calloption.asp (last visited Aug. 17, 2010). When analyzing Treasury bills in GCM 38,369, the IRS focused on GCM 38,285's holding that call options are equivalent to the underlying stock because, like call options and their underlying stock, the "[y]ield rates on Treasury bills and Treasury bill futures will react to changes in economic conditions in a similar manner." GCM 38,369, *supra* note 117. Essentially, "as interest rates change[,]

declared call options to be securities for purposes of § 1091 since they "can be a substitute for trading in the underlying stock and the price of the option is directly related to the price of the underlying stock."[133] By definition, ETFs also serve as a means of replicating a diversified position in the underlying stocks,[134] and the share price of the ETF is directly related to the price of the underlying stocks of the fund.[135] Thus, based on the above analysis,[136] the logical conclusion can be drawn that ETFs should be considered "securities" for purposes of § 1091.

2. Defining "Substantially Identical"

While there is a strong sense that ETFs should be considered "securities" for purposes of § 1091,[137] there is less certainty in the tax community regarding the definition of "substantially identical."[138] As stated previously,[139] while not binding on the definition in § 1091, other examples in the Code where the phrase "substantially identical" is used may indicate a consistent congressional intent for use of the term "substantially identical."[140] Again, however, there is discrepancy between how the term is applied in different areas of the Code and the corresponding Treasury regulations. For example, 26 C.F.R. § 1.148-4(b)(2)(ii) establishes the standard that bonds are substantially identical if their "interest rate, maturity, and payment dates are the same,"[141] essentially setting forth that, for all intents and purposes, the bonds are exactly the same. On the other hand, 26 C.F.R. § 1.199-3(i)(6)(B)(iv) states that computer software is considered substantially identical if it has

the prices of both the Treasury bill and the [Treasury bill] future" will adjust in equivalent amounts. *See id.* Thus, for a case involving the Wash Sale Rule for Treasury bills and Treasury bill futures, like call options and equity ownership in the underlying stock, investors could "avoid the purpose of the wash sales provisions if they can recognize a loss on their 'wash sales,'" realized by selling the Treasury bill or closing out the future contract and maintaining their position in the alternative investment. *Id.*

132. I.R.S. Gen. Couns. Mem. 38,285 (Feb. 22, 1980)

133. GCM 38,369, *supra* note 117.

134. *See supra* text accompanying note 75.

135. *See supra* text accompanying note 77.

136. *See supra* notes 130–35 and accompanying text.

137. *See supra* notes 134–35.

138. "Considering the lack of a concrete definition of 'substantially identical' securities by the IRS in the case of ETFs, opinions widely diverge" with respect to Congress's intent in § 1091. *See* Meziani, *supra* note 59, at 277.

139. *See* GCM 38,369, *supra* note 117.

140. *Id.*

141. "Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same." 26 C.F.R. § 1.148-4 (b)(2)(ii) (1999).

the "same functional result . . . and has a significant overlap of features,"[142] thus providing a standard that indicates that the items in question should be fairly similar, but do not have be exactly identical.[143]

The United States Court of Appeals for the Third Circuit in *Hanlin v. Commissioner*[144] sought to bring some clarity to the term "substantially identical." The Third Circuit asserted that, in the context of the Wash Sale Rule, "[t]he words 'substantially identical' indicate that something less than precise correspondence will suffice to make the transaction a wash sale."[145] But rather than define how much "less than precise correspondence" is necessary to find that securities are "substantially identical," the Third Circuit stated that "the 'something' less that is required consists of economic correspondence exclusive of differentiations so slight as to be unreflected in the acquisitive and proprietary habits of stocks and securities."[146] In other words, *Hanlin* held that the security does not have to be identical, but it cannot leave the taxpayer in the same economic position in which he was prior to the Wash Sale transaction.[147]

While helpful in explaining that "substantially identical" *can* be less than *entirely* identical,[148] *Hanlin* provides little help in determining the boundaries of what constitutes "substantial" in complex situations of trading ETFs in exchange for stocks, mutual funds, or other similar ETFs where the securities will be close to identical, but not entirely identical. And the IRS has remained uncommitted to defining the boundaries of "substantially identical," merely stating in its recent Publication 550,[149]

142. "For purposes of (i)(6)(iii)(B) of this section, substantially identical software is computer software that—(1) . . . [H]as the same functional result as the online software described in paragraph (i)(6)(iii) . . . ; and (2) Has a significant overlap of features or purpose with the online software described in paragraph (i)(6)(iii) . . ." 26 C.F.R. § 1.199-3(i)(6)(B)(iv) (2008).

143. The word "significantly" is not defined in the Code for purposes of 26 C.F.R. § 1.199-3(i)(6)(B)(iv), but common usage indicates that "significantly" means "of a noticeably or measurably large amount," but not direct correlation. *See Significant*, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/significant (last visited Aug. 17, 2010).

144. Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939).

145. *Id.* at 430 (citing Recent Case, 52 HARV. L. REV. 530, 531 (1939)).

146. *Hanlin*, 108 F.2d at 430. The Third Circuit further explains that

> [w]hen the taxpayer's ability to pay is diminished by the realization of losses, these losses should and do operate to reduce his tax. The wash sales provision is designed to eliminate fictitious losses. As losses are a matter of economics, so the fiction lies in the lack of any change in the economic position on the part of the taxpayer. *Id.*

147. *Id.*

148. *Id.*

149. DEP'T OF THE TREASURY, I.R.S. PUBLICATION 550, INVESTMENT INCOME AND EXPENSES (INCLUDING CAPITAL GAINS AND LOSSES) (Jan. 4, 2009), *available at* http://www.irs.gov/pub/irs-pdf/p550.pdf [hereinafter I.R.S. PUBLICATION 550].

which was intended "for use in preparing 2009 [tax] returns,"[150] that, "[i]n determining whether stock or securities are substantially identical, you must consider all the facts and circumstances in your particular case."[151]

B. Administrative Concerns

With the IRS putting such emphasis on an individual taxpayer's "particular case,"[152] was the IRS suggesting that it should define "substantially identical" for each individual tax situation? While an objective determination by the IRS of each individual taxpayer's position is often the purest way to determine tax liability,[153] Congress has routinely

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150. *Id.* at 1.

151. I.R.S. PUBLICATION 550, *supra* note 149, at 57. When considering one's particular facts and circumstances, "important features to consider include the issuer of the securities, as well as the securities' yield, duration, asset value, conditions of retirement, maturity dates, and if applicable, earlier call provisions." KLEINROCK'S TAXEXPERT ANALYSIS AND EXPLANATION § 77.4 (2009).

152. *Id.*

153. Consider, for example, the dissenting opinion's argument in *Benaglia v. Comm'r*, 36 B.T.A. 838, 841 (1937). While the majority set forth that the value of meals and lodging provided to an employee by his employer are not taxable income to the employee if they are "not for his personal convenience, comfort or pleasure, but solely because he could not otherwise perform the services required of him," the dissent argued that the proper question was "whether or not [the taxpayer] was financially benefited by having living quarters furnished to himself and wife." *Benaglia*, 36 B.T.A. at 839, 842 (Arnold, J., dissenting). In turn, the dissent set forth that, "to the extent [the housing and meals] benefited [the taxpayer] it was compensation . . . and taxable to him as income." *Id.* at 842. Essentially, in determining the deficiency of the taxpayer, the dissent believed that the IRS must look to the individual situation of the taxpayer and determine how much he was enriched by receiving the housing and meals at no expense. *See id.* Realizing the need to balance the administrative concerns of such a standard, Congress decided not to focus on the individual's personal enrichment when it codified the majority's opinion in 26 U.S.C. § 119 (2006), effective in 1998, which set forth in subpart (a) that, with respect to

> [m]eals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment [,] [t]here shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if—(1) in the case of meals, the meals are furnished on the business premises of the employer, or (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

26 U.S.C. §§ 119(a)(1)–(2) (2006). Consider also the case of term life insurance, which Professor Peter J. Wiedenbeck, the Joseph H. Zumbalen Professor of the Law of Property at Washington University in St. Louis, suggests is purchased for three primary reasons: (1) to "[p]rovide resources for family support in the event of death" of the family wage earner (2) to "[p]rovide resources to replace lost services in the event of death" of a homemaker, and (3) as a death-time gift to adult children as beneficiaries of the policy. Professor Peter J. Wiedenbeck, Joseph H. Zumbalen Professor of the Law of Prop., Federal Income Taxation Lecture at Washington University School of Law (Oct. 19, 2009). Based on the standard set forth in *Raytheon Production Corp. v. Commissioner*, which holds that the purest way to tax damages is to tax the money the same way as the benefit it is replacing (e.g., money received as compensation for lost profits should be taxed because profits are taxable income), it is logical to conclude that the purest way to determine tax liability for term life insurance is to tax the

recognized the need to set forth standards that minimize administrative difficulties for the IRS.[154] With 182,522,000 income tax returns filed in 2009 alone,[155] each with the possibility of an investor attempting to harvest his capital losses through the use of ETFs, the circumstances appear to beg for a less individualized standard that can be readily applied to such situations.

But as the following analysis will demonstrate,[156] a factual inquiry of each individual taxpayer's position would be important to remain consistent with traditional standards of taxation.[157] Further persuasion for individual analysis is provided by the standard set forth by the Canada Customs and Revenue Agency for administering Canada's "Superficial Loss" Rule.[158] Similar to the United States' Wash Sale Rule, Canada's

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insurance based on what the insurance is replacing. *See* Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944). To implement this standard for life insurance, however, would require that close attention be paid to each taxpayer's individual reasons for purchasing the insurance, leading once again to administrative concerns. *See* Wiedenbeck, *supra*. Consequently, Congress ignored the "pure" method of taxation and set forth a single rule in § 101 to be applied in all circumstances regarding life insurance. *See* 26 U.S.C. § 101 (2006).

154. *See supra* note 153; *see also* 26 U.S.C. § 63 (2006) (setting forth a standard deduction available to all taxpayers who choose not to file itemized deductions, reducing the administrative considerations required by the IRS); 26 U.S.C. § 1031 (2006) (allowing the IRS to avoid a difficult valuation process for exchanges in like-kind property by providing that a taxpayer can defer the recognition of any gains realized from the exchange of such property if certain conditions are satisfied). Also consider 26 U.S.C. §§ 61(a), 102(a), 262, 170(a), which combine to provide that the donee of a gift, despite being enriched, is not taxed on the gift; whereas the donor of the gift, despite being disenriched, receives no tax deduction for his gift. Although § 61(a) provides that a taxpayer should be taxed on "all income from whatever source derived," the donee is not taxed for administrative reasons. 26 U.S.C. § 61(a) (2006). Taxing the donee while providing a tax deduction to the donor would create an incentive to make intrafamily gifts from donors in high tax brackets to donees in low tax brackets, while taxing the donee and not providing a deduction to the donor would lead to the IRS having no way to verify if a gift was given. Professor Peter J. Wiedenbeck, Joseph H. Zumbalen Professor of the Law of Prop., Federal Income Taxation Lecture at Washington University School of Law (Nov. 19, 2009). If the IRS had no way to know if a gift was given, the donee would only have to pay taxes if he was honest and felt compelled to do so. *Id.*

155. INTERNAL REVENUE SERVICE, IRS DATA BOOK, TABLE 2: NUMBER OF RETURNS FILED BY TYPE OF RETURN 4 (2009), *available at* http://www.irs.gov/pub/irs-soi/09databk.pdf (explaining that the 2009 figures provided were last updated in June 2010). The total number of returns filed in the United States for 2009, including estate tax, gift tax, employment taxes, tax-exempt organizations, excise taxes, and other supplemental documents was 236,503,000. *Id*.

156. *See* discussion *infra* Parts VI.A–C.

157. *See* discussion *infra* note 163 (explaining the Supreme Court's traditional emphasis on focusing on the substance of the transaction rather than the form).

158. Under section 54 of the Canadian Income Tax Act,

> [a] capital loss will be defined as superficial if, during the thirty days on either side of the date of sale that triggered the loss, the taxpayer or an affiliated person (i.e., his/her spouse or a corporation controlled by the taxpayer or his/her spouse) purchased that same property, or one that is identical to that property.

Dan Hallett, *Avoid Superficial Losses: Save Tax and Maintain Desired Exposure*, STERLING MUTUALS, INC., http://www.sterlingmutuals.com/Research/Weekly/Telus_Superficial_16nov2001.

Superficial Loss Rule seeks to determine whether property acquired within thirty days of selling a capital asset for a loss is the "same property or one that is identical to that property"[159] that was previously sold. Accordingly, Canadian tax officials have defined "identical" properties as those "which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another."[160] To make this determination, the Canada Customs and Revenue Agency has stated that it is essential to "compare the inherent qualities or elements which give each property its identity."[161] Essentially, Canada has set forth a standard that is truly individual and factual in nature,[162] a standard the IRS should also look to utilize when defining "substantially identical."

VI. DETERMINING THE PROPER ANALYSIS OF ETFS UNDER THE WASH SALE RULE

With administrative concerns in mind, U.S. courts have frequently sought to understand Congress's intent for various statutes throughout the Code, consistently focusing on the substance of an individual transaction under review, rather than its form.[163] In like manner, *Hanlin v. Commissioner*'s[164] focus on whether a taxpayer maintains the same

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htm; *see also* Graphic Packaging Can. Corp. v. Canada, [2002] F.C. 1706, 1707 (Can. Que. C.A.) (discussing section 54 of the Canadian Income Tax Act).

159. *Graphic Packaging*, [2002] F.C. at 1707.

160. CANADA CUSTOMS AND REVENUE AGENCY, INTERPRETATION BULLETIN NO. IT-387R2 (Sept. 12, 2002), *available at* http://www.cra-arc.gc.ca/E/pub/tp/it387r2-consolid/it387r2-consolid-e.txt.

161. *Id.*

162. *Id.*

163. The U.S. Supreme Court emphasized the importance of substance over form as early as 1929 in its opinion in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). *Old Colony* involved a situation where a taxpayer's employer paid his income taxes, and the Court addressed whether the payment of these taxes was additional taxable income to the taxpayer. *Id.* at 719–20. The Court ruled that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed," and, thus, the payments were additional income to the taxpayer. *Id.* at 729. The Court refused to distinguish a situation where the taxpayer received additional payment that would subsequently be used to pay his taxes from the situation where an employer directly pays the taxes for the employee. *Id.* Despite the formal difference, the Court focused exclusively on the fact that the two situations were substantively identical. *See id.* The Court later utilized the idea of substance over form in many different situations. One such situation was the Court's establishment of the *Raytheon* replacement rule, which sets forth that damages should be taxed based on the "nature of the basic claim." Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 114 (1st Cir. 1944). Essentially, if the damages were intended to replace profits, they would be taxed as though they were gross income; however, if the damages were to replace imputed income, which is historically not taxable income, the damages would not be taxed. *See generally Raytheon*, 144 F.2d at 114.

164. Hanlin v. Comm'r, 108 F.2d 429 (3d Cir. 1939).

substantive economic position,[165] as opposed to other formal distinctions, suggests that emphasis on substance over form is also appropriate in the case of the Wash Sale Rule. The substantive purpose of the Wash Sale Rule, which is "to prevent . . . recogniz[ing] a loss on the sale of 'securities' while maintaining an identical or nearly identical investment position,"[166] appears relatively straightforward. However, analysis of the following transactions—involving the sale of stocks, mutual funds, or ETFs and the subsequent purchase of ETFs within the thirty-day wash sale period[167]—indicates that such a standard is anything but administratively clear.

A. Selling Stock Shares and Subsequently Buying ETF Shares

A long-accepted practice of financial advisors is to suggest that investors "who are truly concerned about violating the wash-sale rule while harvesting their losses . . . maintain exposure to the market by . . . purchasing shares in the" specific ETF.[168] Essentially, the investor would realize a capital loss by selling shares of a corporation's stock (e.g., Microsoft Corporation (MSFT)[169]) for less than the basis[170] in the stock and then immediately purchase an ETF that not only includes exposure to the industry in which that corporation operates but also holds shares of that corporation as part of its index (e.g., Technology Select Sector SPDR (XLK)[171]). If the investor in the above example were to sell his stock in MSFT for a loss and then quickly purchase XLK, he would have the opportunity to benefit from an increase in the stock price of MSFT, since 10.64% of XLK's holdings are in MSFT.[172] While there is definitely a

165. *See id.* at 430.

166. *See* GCM 38,369, *supra* note 117.

167. *See* 26 U.S.C. § 1091(a) (2006).

168. *See* Meziani, *supra* note 59, at 277.

169. *See Microsoft Corporation (MSFT)*, YAHOO! FIN., http://finance.yahoo.com/q?s=MSFT (last visited Aug. 17, 2010).

170. "The cost basis of any investment is the original value of an asset adjusted for stock splits, dividends and capital distributions. . . . At the most basic level, the cost basis of an investment is just the total amount invested into the company plus any commissions involved in the purchase." *How Do I Figure Out My Cost Basis on a Stock investment*, INVESTOPEDIA.COM, http://www.investopedia.com/ask/answers/05/costbasis.asp?viewed=1 (last visited Aug. 17, 2010). "*Basis* is usually cost, but there are a number of important exceptions." WILLIAM D. ANDREWS & PETER J. WIEDENBECK, BASIC FEDERAL INCOME TAXATION 26 (Vicki Been et al. eds., Wolters Kluwer 6th ed. 2009) (citations omitted); *see also* 26 U.S.C. § 1012 (2006).

171. *See Technology Select Sector SPDR (XLK)*, YAHOO! FIN., http://finance.yahoo.com/q?s=xlk (last visited Aug. 17, 2010).

172. *Holdings for Technology Select Sector SPDR (XLK)*, YAHOO! FIN., http://finance.yahoo.com/q/hl?s=XLK (last visited Aug. 17, 2010). The top ten holdings of XLK make up 63.07% of the total

formal difference in name and investment type between MSFT and XLK,[173] there is, more importantly, a significant substantive difference in the risk of the investments that prevents the investor from remaining in the same economic position he was in prior to the transaction. Essentially, the investment in MSFT places all of the investor's risk within a single corporation, whereas the investment in XLK diversifies that risk among a variety of sectors and corporations.[174]

B. Selling Mutual Fund Shares and Buying ETF Shares

Similar to the difference in risk that pronounces a share of stock in a corporation as not "substantially identical" to an ETF,[175] the substantive differences in risk between an actively managed mutual fund and an ETF should also distinguish these two investments as not "substantially identical."

The IRS has explicitly stated that, "[o]rdinarily, shares issued by one mutual fund are not considered to be substantially identical to shares issued by another mutual fund,"[176] but should this formal declaration be understood to also mean that shares of a given mutual fund are not substantially identical to shares of a particular ETF? Not necessarily, as the focus should be on whether the investments substantively leave the investor in the same economic position.[177] Consistent with the tax community's traditional emphasis on substance over form,[178] the rationale for why two mutual funds are not "substantially identical" should be based on the fact that they have different risks associated with them,[179] not the formalistic reason that they are merely different in name.

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holdings of the ETF, including the following: Apple Inc. (10.19%), Microsoft Corporation (10.03%), International Business Machines (7.21%), Cisco Systems, Inc. (6.64%), AT&T Inc. (6.62%), Google Inc. (5.47%), Intel Corporation (4.63%), Hewlett-Packard Company Common (4.37%), Oracle Corporation (4.37%), and Verizon Communications (3.54%). *Id.*

173. *See Microsoft Corporation (MSFT)*, *supra* note 169; *Technology Select Sector SPDR (XLK)*, *supra* note 171.

174. *See* sources cited *supra* notes 169, 171–72 and accompanying text.

175. *See id.*

176. DEP'T OF THE TREASURY, I.R.S. PUBLICATION NO. 564, MUTUAL FUND DISTRIBUTIONS 8 (Feb. 17, 2010). The Publication further states that "[f]or more information on wash sales, see Publication 550," which, as explained previously, does not take a firm stance on the issue. *See* I.R.S. PUBLICATION 550, *supra* note 149, at 56.

177. *See supra* notes 163–66 and accompanying text.

178. *Id.*

179. "Mutual funds face risks based on the investments they hold." Proactive Financial Planning Center, *Mutual Fund Risk*, OPEN-IRA.COM, http://www.open-ira.com/Education_Center/3c_Mutual_Fund_Risk.htm (last visited Aug. 17, 2009) [hereinafter *Mutual Fund Risk*]. Each mutual fund will have unique risks associated with it, including, but not limited to, the following: currency risk

Thus, while it may appear "[f]rom the IRS's perspective . . . [to be] a hard ruling"[180] to determine whether it is a violation of the Wash Sale Rule when selling shares of an actively managed mutual fund at a loss and then purchasing shares of an ETF that tracks the same index within a thirty-day period, focusing on the risks that are present in the transaction clarifies the analysis.[181] For example, consider an investor who sells his stake in the Vanguard 500 Index Fund (VFINX)[182]—an actively managed mutual fund that seeks to track the S&P 500—and then quickly purchases shares of an ETF that tracks the S&P 500, such as S&P Deposit Receipts (SPY).[183] Because this investor would be able to maintain a similar market position, it would appear that the securities are "substantially identical."[184] However, like the risks that distinguish one mutual fund from another, certain differences in risks also distinguish VFINX from SPY. First, they are formally different because they are issued by different companies.[185] Second, and more importantly, the substantive differences in their structural characteristics lead to different risks.[186] To begin with, the mutual fund (VFINX) can only be "bought or sold . . . at the end of the day," whereas SPY, an ETF, "trades continuously throughout the day."[187] Furthermore, an actively managed mutual fund is administered by a fund manager who buys and sells securities to further the objective of the fund, exposing the investor to the risks of that manager's decisions.[188] An ETF, however, is designed to maintain a fixed portfolio created to track the designated index,[189] eliminating any risk of human discretion and leaving

(possibility that foreign investments will lead to reduced returns due to a "rise in the value of the U.S. dollar"), industry risk ("possibility that . . . stocks in a[n] . . . industry will decline in price due to developments in that industry"), manager risk ("possibility that an actively managed mutual fund's investment adviser will fail to execute the fund's investment strategy effectively resulting in the failure of stated objectives"), and market risk (possibility that the prices of a "stock fund or bond fund" will "decline"). *Id.*

180. *See* Meziani, *supra* note 59, at 276.

181. *See Mutual Fund Risk*, *supra* note 179.

182. *See Vanguard 500 Index Fund (VFINX)*, *supra* note 102.

183. *See Id.*.

184. *See* Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939).

185. *See* Meziani, *supra* note 59, at 276.

186. *Id.*

187. *See* Meziani, *supra* note 59, at 276; *see also supra* text accompanying notes 69–71.

188. *See Mutual Fund Risk*, *supra* note 179; *see also Investment Strategy and Policy*, VANGUARD, https://personal.vanguard.com/us/FundsStrategyAndPolicy?FundId=0040&FundIntExt=INT (last visited Aug. 17, 2010) (stating, under the investment policy of the fund, that "[t]o track its target index as closely as possible, the fund attempts to remain fully invested in stocks " However, "[t]he fund may temporarily depart from its normal investment policies and strategies when doing so is believed to be in the fund's best interest, so long as the alternative is consistent with the fund's investment objective.").

189. *See Unit Investment Trust*, *supra* note 62; *see also ETFs SPY Overview*, *supra* note 90

the investor in a substantively different economic position than he was in when investing in the mutual fund.

In addition, while the IRS has failed to formally articulate the risk distinction set forth above,[190] investment advisors have developed an industry-accepted "list of transactions that are generally considered to be acceptable under the wash sale rule set forth in Section 1091."[191] Among this list, one will find that "sell[ing] an actively managed fund and buy[ing] an index fund regardless of the fund company"[192] is generally accepted to not be a transaction involving "substantially identical stock or securities."[193]

C. Selling ETF Shares and Buying ETF Shares

Missing from the list of industry-accepted transactions[194] is the situation in which an investor sells his ETF shares at a loss, deducts his capital loss, and then purchases shares of an ETF that tracks the same index but was created by a different company.[195] Such a transaction seems to allow an investor to maintain the same economic position since the two ETFs are tracking the same index and thus, in theory, should be accurately tracking the price of the underlying securities of the index.[196] In turn, the ETFs, like the previously discussed mutual funds,[197] must be analyzed to determine if any substantive differences between the funds are significant enough to render a "change in [the taxpayer's] economic position."[198] The following analysis will focus on three factors to determine if ETFs

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(stating that SPY is "a unit investment trust established to accumulate and hold a portfolio of the equity securities that comprise the Standard & Poor's 500 Composite Stock Price Index").

190. *See supra* notes 181–89.

191. While trying to discern the Wash Sale Rule, industry practitioners have developed a list of four mutual fund transactions that are "generally considered to be acceptable" under Section 1091. Lee C. McGowan, *Tax-Loss Harvesting: The Rebalancing Act*, J. FIN. PLAN. E-NEWSLETTER (Dec. 2008), http://www.fpajournal.org/BetweentheIssues/LastMonth/Articles/Tax-LossHarvestingtheRebalancingAct/. This list includes the following:

> 1. Sell one index fund and buy another index fund, if the indexes of the two funds are not the same index (e.g., S&P 500 for Russell 1000). 2. Sell one actively managed fund and buy a fund at another company with different portfolio managers. 3. Sell an index fund and buy an actively managed fund regardless of the fund company. 4. Sell an actively managed fund and buy an index fund regardless of the fund company.

Id.

192. *Id.*

193. *Id.*

194. *See* McGowan, *supra* note 191.

195. *See, e.g.*, *supra* note 103.

196. *See supra* text accompanying note 77.

197. *See supra* Part VI.B.

198. *See* Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939).

tracking the same index are "substantially identical": whether the funds are from different companies,[199] the price of the securities,[200] and the holdings of the ETFs themselves.[201]

1. Different Companies

The IRS's Publication 550 presents the formalistic standard that, "[o]rdinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases."[202] While "'ordinarily' has been a source of angst within the investment community"[203] in general, ambiguity with respect to the phrase "in some cases" seems more at issue in this case.

The question becomes whether a transaction that involves selling an ETF at a loss and buying an ETF from a different company that tracks the same index within thirty days is one of the "cases" where the securities may be deemed "substantially identical." The argument against ETFs being one of the exceptions to this rule is fairly strong when looking at Treasury Regulation § 1.233-1(d)(1).[204] The Regulation states that "[i]n general, as applied to stocks or securities [in section 1233], the term ['substantially identical'] has the same meaning as the term 'substantially identical stock or securities' used in section 1091, relating to wash sales of stocks or securities."[205] In turn, when analyzing § 1.1233 as though it were explaining "substantially identical" for use in § 1091, it becomes clear that the exceptions to the general rule that securities of different corporations may not be substantially identical primarily involve situations where the securities are transferable into other securities,[206] which is not the case

199. *See infra* Part VI.C.1.

200. *See infra* Part VI.C.2.

201. *See infra* Part VI.C.3.

202. *See* I.R.S. PUBLICATION 550, *supra* note 151, at 56.

203. McGowan, *supra* note 191. Furthermore, while the IRS "ordinarily" focuses on the formal distinction between securities of different companies, the word "ordinarily" may indicate that the agency is still maintaining its overall focus on looking at the substance of the transaction over the form of the transaction. *See generally supra* note 163 and accompanying text.

204. 26 C.F.R. § 1.1233-1(d)(1) (2009).

205. *Id.*

206. The regulation interpreting 26 U.S.C. § 1233, found in 26 C.F.R. § 1.1233-1(d)(1), suggests that if one security is transferable into another security, it is more likely to be considered "substantially identical." *See id.* According to the regulation,

> [i]n certain situations [securities that are transferable into other securities] may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a

here. Therefore, based on the above analysis,[207] as well as the tax community's traditional emphasis on substance over form,[208] the purely formal distinction between ETFs created by different companies should not be dispositive of whether they are substantially identical.

2. Price

Because the ETFs are tracking the same index, there is often very similar movement in price between the different funds.[209] For example, consider two ETFs that are overseen by different companies, but that both track the emerging markets index: Vanguard Emerging Markets ETF (VWO)[210] and iShares MSCI Emerging Markets Index ETF (EEM).[211] From March 21, 2005, through October 22, 2007, VWO experienced a 146% increase in share price, while EEM experienced a 145% increase in share price.[212]

Despite the similarity in price movement, Mr. Robert Willens, CPA,[213] sets forth a strong argument that the correlation should be indeterminate.[214] Mr. Willens commented that "if you sold GM and bought Ford, it would make no difference if their price charts looked like a perfect overlay."[215] In Mr. Willens's opinion,

> [c]orrelation of price and returns is only a factor in determining securities to be substantially identical in cases where (a) the securities of two different companies are undergoing merger, or (b) the securities of one company are convertible into one another—that

> corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property.

Id.

207. *See generally supra* Part VI.C.1.

208. *See* I.R.S. PUBLICATION 550, *supra* note 149, at 56; *see also supra* note 163 and accompanying text.

209. *See generally* Shaw, *supra* note 31.

210. *Historical Prices for Vanguard Emerging Markets Stock ETF (VWO)*, YAHOO! FIN., http://finance.yahoo.com/q/hp?s=VWO (last visited Aug. 17, 2010).

211. *Historical Prices for iShares MSCI Emerging Markets Index (EEM)*, YAHOO! FIN., http://finance.yahoo.com/q/hp?s=EEM (last visited Aug. 17, 2010).

212. *See supra* notes 210–11 and accompanying text.

213. *See generally* Shaw, *supra* note 31 (providing a brief introduction to Mr. Robert Willens, CPA).

214. *See generally id*.

215. *Id.*

> correlation of return and price movement is not a basis for . . . funds to be determined to be "substantially identical."[216]

Other theorists strongly disagree, claiming that "[i]f you can lay the price graph for your new investment on top of the price graph for the old one and never see a significant disparity," which would likely be the case for two ETFs tracking the same index, then "the investments should be considered substantially identical for purposes of the wash sale rule."[217] These theorists are focused on the standard set forth in *Hanlin* regarding changes in economic position.[218] They claim that "the bottom line is [that] risk and the wash sale rule are tied together. If you have a strategy that completely eliminates risk from your sale and repurchase, it's likely that you have a wash sale. You can't report a loss for tax purposes without changing your investment position."[219]

The main problem, however, with saying that any two funds that demonstrate similar movements in price will maintain the same level of risk is that "[p]erhaps the most fundamental shortcoming of any ETF is its failure to adhere reliably to the index to which it is purportedly benchmarked," primarily due to "management fees, taxes, and other subtle sources of investment friction."[220] This "[t]racking error will vary from fund to fund," even between funds that track the same index.[221] Therefore, even if two funds have experienced the same price movements over a given period of time, differences in tracking error between the funds create the risk that the funds will not have the same price movements in the future.[222]

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216. *Id*.

217. Kaye A. Thomas, *Substantially Identical Securities*, TAX GUIDE FOR INVESTORS (June 1, 2007), http://fairmark.com/capgain/wash/wsident.htm.

218. *See* Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939).

219. *See* Thomas, *supra* note 217.

220. *See* Birdthistle, *supra note* 63, at 97–98 (citation omitted).

221. *Id.*

222. The *Financial Times* explains how tracking error can vary from fund to fund through an example. *See id.*

> For example, Lipper calculates that the Lyxor CAC 40 ETF had an annualized tracking error of 2.33 per cent in 2005 and 1.99 per cent in 2006. In contrast, the Indexis ETF tracking the same index recorded annualized tracking errors of 5.44 per cent and 4.16 per cent for 2005 and 2006 respectively.

Id. at 98 (citing Simon Hildrey, *On the Trail of Exchange Traded Funds*, FIN. TIMES (LONDON), Aug. 13, 2007, at 5).

3. Holdings

Often, the reason that two ETFs tracking the same index demonstrate similar price movements is that, despite being created by different companies, the funds have similar holdings of stocks. For example, consider the holdings of the two previously mentioned ETFs that track the emerging markets index: VWO and EEM.[223] The similarity between the top four industry holdings (represented as a percentage of the entire holdings) of these two ETFs is noteworthy: Industrial Materials (VWO: 16.87%, EEM: 19.14%); Energy (VWO: 12.6%, EEM: 12.36%); Telecommunications (VWO: 12.55%, EEM: 12.12%); and Financial Services (VWO: 21.13%, EEM: 22.22%).[224] Thus, the question becomes whether using these two ETFs to harvest capital losses would leave an investor in the same economic position since the funds maintain similar, but not identical, holdings.

Ms. Erika W. Nijenhuis, a prolific author on issues of taxation and a partner in the New York office of Cleary Gottlieb Steen & Hamilton,[225] believes that the underlying holdings of mutual funds should not be a consideration for transactions involving "the disposition and acquisition of baskets of stock or interests therein."[226] Ms. Nijenhuis believes that "such transactions generally should not be treated as wash sales, even if there are some underlying stocks held by both funds."[227] This opinion appears consistent with the limited case law[228] on this issue for mutual funds, which "preclude[s] looking through the stock of the mutual fund to the

223. *See Holdings for Vanguard Emerging Markets Stock ETF (VWO)*, YAHOO! FIN., http://finance.yahoo.com/q/hl?s=VWO (last visited Aug. 17, 2010); *see Holdings for iShares MSCI Emerging Markets Index (EEM)*, YAHOO! FIN., http://finance.yahoo.com/q/hl?s=EEM (last visited Aug. 17, 2010).

224. *See* sources cited *supra* note 223.

225. *See* Erika W. Nijenhuis, *Wash Sales Then and Now*, 82 TAXES 181, 181 (2004); *see also* Biography of Erika W. Nijenhuis, CLEARY GOTTLIEB, http://www.cgsh.com/enijenhuis (last visited Aug. 17, 2010).

226. *See* Nijenhuis, *supra* note 225, at 187.

227. *Id.*

228. *See, e.g.*, Knox v. Comm'r, 33 B.T.A. 972 (1936). In *Knox,* a taxpayer disposed of 11,550 shares of stock in an operating company for a loss, claimed that loss on his tax return, and purchased (within the wash sale period) 11,550 shares of stock in a holding company organized exclusively for trading in the operating company's stock. *Id.* at 972–73. The IRS argued that this transaction was a violation of the Wash Sale Rule. *Id.* The court held that, based on the holding in *Eisner v. Macomber*, 252 U.S. 189, 213 (1920), the "separateness of a corporation and its stockholders may not be disregarded," even though the holding company's only asset was shares of the operating company. *Knox*, 33 B.T.A. at 975. The petitioner only owned stock in the holding company, and the "indirect interest which he thus had in the [operating company's] shares belonging to the [holding company] was not substantially identical to the [operating company's] shares which he owned prior to the transaction." *Id.*; *see also* Nijenhuis, *supra* note 225, at 187.

underlying assets."[229] By refusing to look at the similarity in the underlying securities, Ms. Nijenhuis and the case law to which she refers focus their attention exclusively on the form, rather than the substance, of the transaction. This approach may be appropriate for mutual funds, where the underlying stocks constantly change so that the investor may not know the underlying securities at any given time.[230] In the case of ETFs, however, the holdings of the fund are transparent to the investor,[231] and, thus, the holdings should be analyzed to determine if the risks of the two funds are similar.

Therefore, while similarities in price or differences in the companies creating the ETFs should not alone be dispositive on whether two ETFs are substantially identical,[232] a proper standard of analysis should be based on the underlying holdings of the funds. Accordingly, if the focus is properly shifted to the substance of the individual transaction,[233] and the underlying securities held by the two ETFs in question are similar enough to leave the investor in the same economic position in which he was prior to harvesting his losses,[234] then it should be appropriate to find a violation[235] of the Wash Sale Rule.[236]

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229. *See* Nijenhuis, *supra* note 225, at 187.

230. *Id.* at 188; *see also Portfolio of the Vanguard 500 Index Fund*, VANGUARD, https://personal.vanguard.com/us/FundsAllHoldings?FundId=0040&FundIntExt=INT&tableName=Equity&tableIndex=0&sort=marketValue&sortOrder=desc (last visited Aug. 17, 2010) (setting forth the 503 holdings for the VFINX mutual fund, but on Aug. 17, 2010, the holdings were only current through June 30, 2010); *cf. Technology SPDR—XLK*, SELECT SECTOR SPDRS, http://www.sectorspdr.com/spdr/composition/?symbol=XLK (last visited Aug. 17, 2010) (setting forth the eighty-four holdings for XLK, an ETF tracking the technology sector).

231. The ETF must maintain its "ironbound connection to the index" at all times through its underlying holdings. *See* Birdthistle, *supra* note 63, at 82. These holdings are fairly transparent to investors through reporting of sites such as YAHOO! FINANCE, which publishes the top ten holdings of all the ETFs for which it provides data. *See, e.g.*, *Holdings for Ultra Semiconductor ProShares (USD)*, YAHOO! FIN., http://finance.yahoo.com/q/hl?s=USD (last visited Aug. 17, 2010).

232. *See supra* Part VI.C.1–2.

233. Focusing on the substance of the transaction rather than the form of the transaction is consistent with historical tax practices. *See generally supra* note 163.

234. *See* Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939).

235. If a transaction is found to be in violation of the Wash Sale Rule, the losses claimed are not deductible. *See* 26 U.S.C. § 1091(d) (2006). The basis in the property is subsequently increased or decreased "by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of." *Id.* Essentially, by adjusting the basis of the newly purchased property according to the disallowed deductions, the losses on the sold property are deferred until the sale of the newly acquired property that was found "substantially identical" to the sold property. See *supra* note 170 for an explanation of basis.

236. In the author's opinion, it does not seem appropriate to take this discussion further than to make a proposal for which analysis is proper to determine if two ETFs are substantially similar. To make a proposal that a specific percentage of similarity between the holdings of different funds should cause the funds to be substantially identical would create nothing more than an arbitrary proposal.

VII. CONCLUSION

As investors continue to use ETFs more often for tax harvesting purposes,[237] establishing clarity for the use of the phrase "substantially identical stock or securities" in the context of the Wash Sale Rule has become increasingly important. While it was explained that there is little argument that ETFs are "securities" for purposes of the Wash Sale Rule,[238] an individual understanding of the transaction at hand is needed to determine if different securities are "substantially identical."

Based on the analysis previously set forth, it becomes clear how important incorporating the traditional tax philosophy of "substance over form"[239] is to analyzing whether a transaction leaves an investor in the same economic position under *Hanlin*.[240] By focusing on the substance of the transaction, significant differences can be drawn between the risks of ETFs and both individual stocks[241] and actively managed mutual funds.[242] These differences provide two conclusions. First, selling shares of stock in a corporation for a loss and subsequently buying an ETF that tracks that corporation's industry does not leave the investor in the same economic position because the risk is diversified across various corporations, rather than concentrated in one corporation.[243] Furthermore, selling an actively managed mutual fund for a loss and buying an ETF that tracks the same index does not leave the investor in the same economic position since the investor is no longer subject to the decisions of the mutual fund manager.[244] Because the taxpayer is not in the same economic position following these transactions, the securities should not be considered "substantially identical" for purposes of the Wash Sale Rule.[245]

On the other hand, selling an ETF for a loss and buying a different ETF that tracks the same index within a thirty-day period may leave an investor

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Based on nothing more than what the author felt was appropriate, such a proposal could range anywhere from 0% to 100% similarity in the funds' holdings. Accordingly, Congress, the Treasury, and the IRS must be left with the responsibility to balance the policy objectives discussed in this Note with administrative concerns, in order to determine exactly how similar the holdings of the ETFs must be for a taxpayer to maintain the same economic position following a tax loss harvesting transaction.

237. *See supra* notes 81–97 and accompanying text.

238. *See supra* note 136.

239. *See supra* note 165.

240. *See* Hanlin v. Comm'r, 108 F.2d 429, 430 (3d Cir. 1939) (asserting that the purpose of the Wash Sale Rule is to prevent investors from taking advantage of fictitious losses).

241. *See supra* notes 168–74 and accompanying text.

242. *See supra* notes 175–93 and accompanying text.

243. *See supra* text accompanying note 174.

244. *See supra* text accompanying notes 188–89.

245. *See Hanlin,* 108 F.2d at 430.

in the same economic position, thus standing in derogation of the purpose of the Wash Sale Rule.[246] Because a mere distinction between the companies creating the ETFs or the similarity between the prices of the ETFs is not conclusive on the issue,[247] an individual analysis must be undertaken of the underlying holdings of the two ETFs owned before and after the transaction.[248] However, other than knowing that the holdings do not need to be 100% identical,[249] it is difficult to define how similar the underlying holdings need to be in order to declare the securities "substantially identical." Without a clear standard from the IRS, an individual inquiry of the facts of each transaction must be made by the IRS, as well as the court that will hear the claim for deficiency in payment, to determine if the transaction allows the investor to maintain a substantively equivalent economic position.[250]

Thus, if the courts utilize the standard set forth in the previous analysis, a word of caution must go out to any investor who seeks to utilize ETFs to harvest losses realized from the sale of other ETF investments. With no prior case law[251] to indicate how closely the holdings of one ETF must be to another in order for them to be found "substantially identical," blindly using an ETF that tracks the same index as the ETF that was previously sold for a capital loss could intensify the pain of an already-losing investment.[252]

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246. *See* GCM 38,369, *supra* note 117.
247. *See supra* Part VI.C.1–2.
248. *See supra* text accompanying notes 233–35.
249. *See Hanlin*, 108 F.2d at 430.
250. *Id.*
251. A Westlaw terms & connectors search under "All Federal Cases" returned zero cases matching the following search terms: "'exchange-traded funds' and '26 U.S.C. 1091' or 'Wash Sale Rule.'"
252. *See* 26 U.S.C. § 1091(d) (2006) (explaining the result of a violation of the Wash Sale Rule).

* J.D. Candidate (2011), Washington University School of Law; B.S.B.A. Economics and Finance/Accounting (2008), Rockhurst University. I would like to thank everyone from the *Washington University Law Review* for their guidance and comments throughout the publication process, as well as my family and friends for their continued support and encouragement. I thoroughly enjoyed the opportunity to explore the policy concerns involving the relationship between the Wash Sale Rule and Exchange-Traded Funds, as this is an issue that I have thought about a lot over the past couple of years when developing my own investment strategies. I hope that this discussion sheds some light on the important issues that must be further addressed by Congress, the Internal Revenue Service, and the Treasury if the uncertainties regarding § 1091 of the Tax Code are ever to be resolved.