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Tax Section

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WASHINGTON, DC

Tax Loss Harvesting: Opportunities & Pitfalls for Funds & Individual Investors

Financial Institutions & Products Committee

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Mark Leeds, Moderator



Mark (mark.leeds@pillsburylaw.com; (212) 858-1080) is a tax partner at the law firm of Pillsbury Winthrop. Mark's professional practice focuses on the tax consequences of a variety of cross-border capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Prior to joining Pillsbury Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then worked at Weil Gotshal.

Team biographies **Matthew Stevens, Panelist**



Background

- ▶ Education
- ▶ Harvard University
- ▶ (J.D., 1990)
- ▶
- ▶ University of Kansas
- ▶ (B.A., 1987)

- ▶ Matthew serves as chair of the annual Practising Law Institute program “Taxation of Financial Products and Transactions.” He has served as chair of the
- ▶ Financial Transactions Committee of the Tax Section of the District of Columbia Bar,
- ▶ and as the chair of the Financial Transactions Committee of the Tax Section of the
- ▶ American Bar Association. He has co-taught the Georgetown University Law Center
- ▶ class entitled “United States Taxation of International Income – II.” He has published
- ▶ a number of articles dealing with international aspects of U.S. income tax and with
- ▶ the taxation of financial products and transactions. Matthew is listed in Chambers
- ▶ USA: America’s Leading Lawyers for Business. From 2002 to 2004, Matthew
- ▶ served as special counsel to the Chief Counsel for the Internal Revenue Service.
- ▶ There, he advised the Chief Counsel regarding published guidance on a wide range
- ▶ of tax issues involving financial products and cross border transactions.

Jack Cummings

- Jack Cummings, of counsel, Alston & Bird LLP, Raleigh, N.C.

Tax Loss Harvesting v. Creation of Tax Benefits

- Taxpayers with sustained losses frequently desire to recognize the loss, but want to hold on to the property based on the belief that it will recover in value (which is particularly true for financial assets due to their price volatility).
- Loss harvesting does not mean engaging in a transaction to create or import an asset with basis in excess of its fair market value.
 - *Stobie Creek v. Commissioner*, 608 F.3d 1366 (Fed. Cir. 2010) (digital currency options contributed to partnership)
 - *ACM P'ship v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998) (contingent installment sale rule allowed uneconomic recovery of basis).
- Taxpayers are not restricted to tax loss harvesting at year-end. Substantial dips in the market price of securities provide tax loss harvesting opportunities. So planning often revolves around creating realization events that can turn into recognized loss.

Harvesting

- To enjoy Code sec. 165 loss allowance for deduction, each of these elements must be present:
 - Taxpayer owns property.
 - Property adjusted tax basis in excess of current economic value (meaning loss has been “sustained”).
 - Event occurs that can turn the sustained loss into a realized loss;
 - disposition of the property, worthlessness, or other permitted loss realization event.
 - No loss disallowance rule or other loss limitation applicable;
 - Individuals deduct losses only from trade or business, transaction entered into for profit; corporations deduct all losses;
 - Sec. 1211 limits capital losses from sale or exchanges of capital asset to capital gains.

The Wash Sale Rules Impact Loss Harvesting

- Wash Sale Rules (Code § 1091). If a security is sold at a loss, but “substantially identical stocks or securities” are acquired during the 61-day period beginning prior to the disposition, the loss is disallowed.
- Code § 1091(d) (sometimes) adds the disallowed loss to the basis of the replacement property.
- Wash sales also apply to losses on dispositions of options and contracts to acquire stocks and securities.
- The acquisition of an option or contract to acquire the securities sold at a loss can trigger the wash sale rules.
- Wash sale rules apply to short positions as well as long positions.
- Cash settled contracts are treated as options or contracts to acquire, as the case may be.

Wash Sales

- What positions are covered by the statutory rules?
- Routine questions
- Planning opportunities
- Common law wash sale rules
- Digital asset exception

Code Section 1091

- What positions are covered by the statutory rules?
 - Long physical positions in stocks and securities
 - Contracts or options to acquire or sell stocks or securities. Does that include—
 - bullet swaps?
 - notional principal contracts?

Code Section 1091

- What positions are *not* covered by the statutory rules?
 - MLP interests
 - Commodities
 - Cryptocurrency
 - Currency
 - ETFs that hold commodities or crypto?

Routine Questions

- Routine questions
 - Bond-for-bond
 - Index fund for index fund
 - Voting stock for non-voting stock
 - ETP for ETP, where underlying is cryptocurrency

Losses on Short Physical Positions

- Covering short physical positions
 - Section 1091(e) appears somewhat narrower than section 1091(a).
 - Only contract to sell referred to is securities futures contracts.
 - What about
 - Notional principal contracts?
 - Bullet swaps?

Short Put Options

- Revenue Ruling 85-87 held that the sale of stock coupled with the sale of a deep in-the-money put option is a wash sale if the put option is substantially certain to be exercised.
- The Ruling does not specify how far in-the-money the put option must be to trigger a wash sale. Look to section 871(m) delta threshold?
- Relatively high level of tax comfort here if delta is low enough, but traders usually don't like the gap risk.

Planning opportunities

- Planning opportunities on the long side
 - Double up trades
 - Short put options
 - Basket swaps
 - Basis hopping transactions
 - Abandonment

Basket Swaps

- The DRD required holding period is tolled when a taxpayer “has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property.”
- This standard is more stringent than the wash sale standard.
- Treasury Regulation § 1.246-5(c)(1) provides guidance (in the dividend received deduction context) when a basket position is considered to substantially overlap with one or more of its components.
- A basket position is considered to substantially overlap if the fair market value of the basket positions is equal to or greater than 70% of the offsetting positions.

Basket Swaps

- The rule for basket positions is not purely mechanical. There is an anti-abuse rule:
- 1. Do changes in the value of the position or the stocks reflected in the position are reasonably expected to *virtually track* (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other positions of the taxpayer; and
- 2. The position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

Basket Swap

- Taxpayer sells 100 shares of Stock X at a loss.
- Within the wash sale period, the taxpayer acquires a long position under a basket swap.
- The basket swap includes 100 shares of Stock X in the notional index.
- The 100 shares of Stock X constitute less than 70% of the fair market value of the notional index.
- The swap is not expected to perform identically to how Stock X performs.

Basket Swap illustration

- Issues with basket swaps
 - Does the rule even apply at all? Serpentine path through section 1259
 - To what extent, if any, can taxpayers hedge the unwanted long exposure?
 - How should we think about the overlap test where the long swap and the short position do not exist simultaneously?
 - Testing dates

Basis hopping

- If an investor has a loss on an index security, positions on which are traded in the options market, such as the S&P 500, it can sell such security.
- Within the wash sale period, the taxpayer then purchases a Section 1256 option to acquire the index. This would be a wash sale and some argue that the loss on the original sale is capitalized into the option.
- At year-end, the taxpayer is required to mark-to-market the option. The gain or loss will include the capitalized loss.
- Any gain or loss is 60/40 gain or loss.

Basis Hopping

- Taxpayer holds 100 shares of Stock X. The taxpayer sells the shares at a loss.
- The Taxpayer buys an out-of-the-money call option on 100 shares of Stock X. Some practitioners believe that the wash sale rules always capitalize the loss on the sale of the physical shares into the call option.
- The Taxpayer then buys 100 shares of Stock X.
- The Taxpayer then sells the out-of-the-money call option. The sale of the option and the purchase of the stock should not trigger a wash sale. Rev. Rul. 58-384.

Basis hopping

- Potential pitfall: Section 1091(d).
 - Loss capitalization is not automatic.
 - Section 1091(a) disallows the loss.
 - Section 1091(d) then adds that loss to the basis of certain property
 - But *which* property?
 - If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility . . . of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the [acquisition price of the property] and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

Straddle rules

- Treas. Reg. §1.1092(b)-1 can apply to defer losses in wash sale type situations, even where section 1091 does not.
- Example:
 - Taxpayer has a bull call spread struck at 100/110, and cash settles the short call for a loss of \$5.
 - Immediately afterwards, taxpayer writes another call that is not substantially identical with the settled call. Later that same year, taxpayer sells the long call for a gain of \$2.
 - At year end, taxpayer still holds the short call with an unrecognized gain of \$7.

Straddle rules

- What result?
 - The original two positions constitute a straddle.
 - The second short call is a successor position to the loss position.
 - Even though the offsetting position (e.g., the long call) is no longer held as of the end of the year, and even though the two short calls were not substantially identical), the straddle rules will defer the loss on the closing of the old short call to the extent of the unrecognized gain in the new short call.

Common law wash sale rules

- *Horne v. Commissioner* involved seats on the floor of a commodity exchange, where the second seat essentially provided no additional economic exposure. Gov't won.
- More common issue, particularly with cryptocurrency, is whether a closed and completed transaction has occurred.
 - E.g., taxpayer agrees to sell cryptocurrency to counterparty.
 - There is an understanding that taxpayer will likely offer to repurchase it at market shortly after the sale at market price, but taxpayer under no obligation to do so.
 - Does taxpayer actually have to deliver the cryptocurrency to have a completed sale?

Abandonment

- PLR 202549014: Parent abandons stock of worthless security in a bankruptcy and claims a worthless stock deduction.
- Code § 165(g)(3) treats a worthless stock deduction of as an ordinary loss for losses in affiliated companies (80% of vote and value).
- Company that became worthless must have derived more than 90% of income has been derived from non-passive sources. PLR holds that 90% test is determined with reference to gains not amount realized.
- Pilgrim's Pride – better after-tax result to abandon stock than to sell & sustain a capital loss.

Questions?