Tax Letter

December 2006, Vol 15 - "ETF" and "Wash Sale Rule"

Dear clients and friends:

First, what is ETF? ETF stands for Exchange Tradable Fund. This type of security can be traded directly in an established Exchange very much like stocks. In this case is the American Stock Exchange (AMEX). It's name ended with the word "fund". This means that it is a type of "mutual fund" and typically it is either organized as a Unit Investment Trust or an open ended Fund. Since the introduction by the American Stock Exchange in about 1993, the popularity of ETFs grew over time. For example, the first EFT was issued as a S&P 500 Index Depositary Receipt (SPDR 500). To day, we have as many ETFs as there are security indices and/or industrial sectors. Each and every one of these ETFs is a basket of securities designed to track either a specific index or industrial sector. Currently, ETFs are designed for different investment objectives, i.e. asset allocation, diversification, and/or hedging.

Second, what is the "wash sale rule" ? Generally, if an investor sold one of the stocks he held and resulted in a loss, the investor will be allowed a capital loss to offset against other capital gain. If the investor bought back the same stock he sold within 30 days, the investor will not be allowed to deduct his loss because he violated the "wash sale rule". What happened if the investor bought exactly the same stock less than 30 days before he sold the stock he originally own ? Again, the loss from selling the stock could not be allowed as a deduction. In other word, if an investor, within 30 days before or after the day of the sale of a security at a loss, purchases a "substantially identical" security, the investor will not be allowed to use the loss because he violated the "wash sale rule". Therefore, the "wash sale rule" prohibits the repurchase of "substantially identical" security within 30 days before or after the sale of a security.

What is "substantially identical" ? The regulations do not define the meaning of "substantially identical ". However, past judicial and administrative rulings did provide taxpayers sufficient insight and guidelines to interpret the term "substantially identical" for purposes of the "wash sale rule". One end of the spectrum would say that same stock issued by the same corporation, definitely, identical. The other end of the spectrum would be different stocks issued by different, unrelated corporations, definitely, not identical. Any thing between these two ends could then be considered either identical or not identical. For example, a common stock and a preferred stock issued by the same corporation have been ruled not "substantially identical". Likewise, two bonds issued by the same corporation but carries different rate of interest and with different maturity dates were also ruled not "substantially identical". Following this set of logic, taxpayers may conclude that :

(1) securities issued by different, unrelated corporations are not "substantially identical" regardless of what they represent; and

(2) different securities issued by the same corporate are not "substantially identical" as long as they are
different, such as Common stock vs Preferred stock.

Accordingly, ETFs issued by different, unrelated companies are not “substantially identical” even they are issued for similar purposes and targets. For example, a ETF structured as SPDR [SPY] and another ETF structured as iShare SP500 [IVV], although they are similar because both ETFs track the same SP 500 companies and both ETFs trade on the same American Stock Exchange like regular stocks; yet they are different because they are issued by two different, unrelated companies, [SPY] is issued by PDR Services LLC and [IVV] is issued by Barclay’s Global Investors. Further, [SPY] is a unit investment trust, while [IVV] is an open-end fund. Therefore, they could be considered not "substantially identical".

Another example is that the iShare Dow Jones Technology [IYW], the SPDR Technology [XLK], and the VIPERS Technology [VHT] are technology ETFs tracking the same or similar industrial sector(s), but they are compiled by different providers and issued by different companies. All of them could be considered as "similar but different", therefore, they are not "substantially identical".

In conclusion, taxpayers will be allowed to deduct their loss by selling certain ETF and immediately buy back a "similar but different" ETF to remain in the same or similar market position and exposure without violating the “wash sale rule”. This is also true for selling shares in a "mutual fund" and immediately buy back shares of a "similar but different" ETF.

Any question, please give us a call at 415-381-0681, or visit our website at www.chochan.com.

Sincerely,

Cho F. Chan, CPA, Inc.