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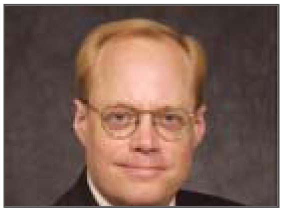

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IRS Won't Defer Your "Flash Crash" Gains

If you don't know what a Flash Crash gain is, consider yourself lucky. Remember May 6, 2010? That was the nutty day the market dropped precipitously. See What Does Flash Crash Mean. Still unexplained, it was a phenomenon that quickly roiled prices. The latest theory is that a mutual fund acting like a hedge fund precipitated it, though personally, I'm sure Roswell, New Mexico was somehow involved. See The Mutual Fund in the 'Flash Crash'. In its wake, the SEC voted June 10, 2010 to enact new rules to automatically stop trading on any stock in the S&P 500 whose price changes by more than 10% in any five-minute period. See SEC Puts In Market Safeguards.

With the market falling off a cliff, there would be big losses, right? Not necessarily. It turns out some investors sold stock at a ***gain*** because of stop-loss orders. A stop-loss order directs a broker to sell at the best price available if the stock reaches a specified price. Because of the whopping and sudden decline in stock prices the afternoon of May 6, 2010, many stop-loss orders were triggered. See Dissecting The Flash Crash.

Many sales were at prices well below prior trades. Many investors incurred losses even though stock prices rebounded. The closing price for many stocks was higher than either the price at which the stop-loss orders were triggered or the price realized on the sales.

In a newly released Information Letter 2010-0188, the IRS responded to a request from investors/brokers that:

1. Investors should be allowed to reinvest in the stock they sold;
2. The replacement stock should be given the same basis as the stock they originally held; and
3. Investors should be excused from recognizing gain.

Appealing as this sounds, the IRS says it doesn't have the authority!

Maybe this makes you think of wash sales, where you sell stock to trigger a loss, and then buy it back. But this is the flip side of a wash sale, and it turns out there's nothing in the tax law to allow you to defer any such gains. In the Notice, the IRS agrees that the wash sale rule of Code Section 1091 can prevent you from recognizing a ***loss***.

> **Loss Example:** Ivan Investor bought 1,000 shares of Biggie stock at $70 at market opening on May 6, 2010, and placed a stop-loss order at $66.50 (5% below the cost of the stock). When the stock declined to $66.50, Ivan's stop-loss order became a market order. It was executed at $61.00, the best available price. The sale resulted in a loss of $9 per share. If within 30 days (before or after the sale), Ivan purchased Biggie stock, the wash sale rules would limit or deny deduction of the loss. The amount of the disallowed loss would be reflected in Ivan's basis in the Biggie stock.

But gains are different, says the IRS.

> **Gain Example:** Iris Investor purchased Smallco stock on July 20, 2009 for $40 per share. Iris placed a stop-loss order at $66.50 (5% below the closing market price of the stock on May 5, 2010). During the flash crash, Iris's stop-loss order was triggered, and her Smallco stock was sold at $66.50 per share. She realized a gain of $26.50 per share. Iris must recognize her gain, even if she bought her shares back the next day.

Other Ideas? There are other non-recognition provisions in the tax code, of course. They include the like-kind exchange rules of Code Section 1031 and the involuntary conversion rules of Code Section 1033. See Ten Things to Know About 1031 Exchanges. Unfortunately, none of these rules apply here, said the IRS.

Leave it to Congress to provide tax relief, said the IRS. (Of course, Congress seems to be having trouble passing tax legislation, so we'll see.)

Think that you don't have to pay tax if you don't have cash? See When You've Got Taxable Income But No Cash.

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