



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

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UIL: 1031.04-00, 1033.01-00

Dear _____ :

This is in response to your May 20, 2010, letter to Commissioner Shulman concerning the May 6, 2010, "flash crash" of the stock market. You point out that many investors had their holdings sold that day because of stop-loss orders and that, in some cases, these investors realized gains subject to tax. You ask that these investors be allowed to reinvest in the stock sold, that the replacement stock be given the same basis as the stock originally held, and that the investors be excused from recognizing gain.

Stop-loss orders direct a broker to sell a stock at the best price currently available if the stock reaches a specified price. As the result of the speed and scope of the decline in stock prices during the afternoon of May 6, 2010, many stop-loss orders, which are executed as market orders, were triggered. The paucity of bids for many stocks resulted in sales at prices significantly below those of prior trades. Those sales triggered additional stop-loss orders and more stock sales at current market prices. Many investors incurred losses as the result of such sales, although stock prices rebounded significantly thereafter. The dramatic recovery in stock prices was a source of frustration to investors whose stock holdings were liquidated as the result of the execution of stop-loss orders during the market decline. The closing price for many stocks was higher than either the price at which investors' stop-loss orders were triggered or the price realized on the sale of stock as a result of the triggering of a stop loss order.

Reinvestment in securities sold at a loss in some circumstances requires application of the wash sale rules set forth in section 1091 of the Internal Revenue Code, so that the loss cannot be recognized fully for federal income tax purposes. Example: An investor bought 1,000 shares of X Co. stock at \$70.00 at the opening of the market 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, the investor's stop-loss order became a market order. As a market order, the order was executed at \$61.00, the best available price. The sale

resulted in a loss of \$9.00 per share to the investor. If the investor, within 30 days before or after the sale of the X Co. stock, purchased X Co. stock, the wash sale rules would apply to limit or deny deduction of the loss. The amount of the disallowed loss would be reflected in the investor's basis in the X Co. stock purchased within 30 days before or after the sale under the stop-loss order.

On the other hand, there is no similar rule allowing nonrecognition of gain on the sale of stock if an investor purchases replacement stock within a prescribed period. Example: An investor who had purchased X Co. stock on July 20, 2009, at a cost of \$40.00 per share had 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, the investor's stop-loss order was triggered, and the investor's X Co. stock was sold at \$66.50 per share. The investor realized a gain of \$26.50 per share on the stock and would be required to recognize the realized gains, i.e., include the gains in gross income, irrespective of whether the investor acquired X Co. stock within a prescribed period, e.g., 30 days, before or after the sale at a loss.

Various nonrecognition provisions in the Code are not applicable. Section 1031 provides for deferral of recognition of gain on like-kind exchanges of property held for productive use in a trade or business or held for investment, but specifically excludes stocks, bonds, and notes from its scope. Section 1033, which provides for deferral of gain if property is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or to money, applies only to dispositions resulting from destruction, theft, seizure, or requisition or condemnation.

In sum, absent the enactment of a relief provision by Congress, there is no authority that would allow the Internal Revenue Service to provide for the nonrecognition of gain for stop-loss orders executed on May 6, 2010.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2005-1, §2.04, 2005-1 IRB 7 (Jan. 3, 2005). If you have any additional questions, please contact our office at _____ (not a toll-free call).

Sincerely,

By: _____
John Aramburu
Senior Counsel, Branch 5
(Income Tax & Accounting)