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Working around the wash-sale rule

Options can be handy tools for loss harvesting, but be careful you don't run afoul of the IRS

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Loss harvesting is popular in December, but it should be done year-round, especially since there are ways to take a loss that don't disturb alpha. There are perfect end runs around the wash-sale rule, most of which use options strategies.

If you sell a stock for a loss and within 31 days buy a call option on that stock, you have violated the wash-sale rule. The penalty of the rule is that the loss on the stock is not crystallized. Instead, the amount of the loss is added to the cost basis of the replacement property; in this case it is the call option.

Here's an example: You bought XYZ at $50. It is now selling for $30. You sell XYZ at $30, creating a $20 loss. However, soon after the stock sale, you buy an XYZ call option with a strike price of $35 for $1. Because the call purchase violated the wash-sale rule, the $20 loss from the stock sale goes to increasing your cost basis in the option from $1 up to $21. That's right — you now own an option worth $1 that has a cost basis of $21. If you sold the call for $1, you'd realize a $20 loss.

Ironically, you are now free to buy XYZ again without concern for the wash-sale rule. The rule does not work the same way when the process is reversed. It is not symmetrical in the treatment of when you sell a call for a loss and then buy the underlying shares.

As long as the call wasn't “substantially identical” to the stock, the purchase of the shares shouldn't violate the wash-sale rule on the loss on the call. A “substantially identical” call option would be one that is very deep in the money and has a very high delta.

Exchange-traded index options are taxed differently than options on individual stocks. Index options are marked to market at year-end. These exchange-traded index puts and calls are taxed under IRC Section 1256, like futures. These index options are taxed as if 60% of the return was long-term gain/loss and 40% short-term gain. This 60/40 split is a trade-off to having to mark the position to market at the end of the year.

Let's say it's Christmastime and you have an unrealized loss on an indexed ETF. You bought this indexed ETF at $100 and it is now trading at $80. If you sell the ETF at $80, you take a $20 loss. Now buy a call option on the index for $5. The $20 loss from the ETF now increases your cost basis on the call by that $20. If the index is at the same level on New Year's, you will have the $20 loss to use come tax day without ever leaving the index because of the year-end marking to market of Section 1256 contracts.

Make sure the options you buy are options on the index and not on the ETF. ETF options are taxed “normally,” like other equity options.

Another popular way to work around the wash-sale rule is to “double up” the position. This entails buying as many shares as you have underwater. After 31 days, sell the first lot of shares and take the loss.

By using specific lot identification, you identify the shares that are sold as those you bought long ago at the higher cost basis. Those not enamored of buying more shares of an already disappointing investment should be aware that the second lot of shares could be hedged with put options without disturbing the desired loss harvesting.

Note: This process must be started by Thanksgiving in order for 31 days to elapse before year-end.
It may not be entirely clear whether or not the wash-sale rule applies to master limited partnerships. Either way, I'd think twice before heading down that path if you've held them for a while.

If you take a loss on an MLP, you will trigger the recapture of ordinary income for every dollar of income you received as a “return of capital.” As the recapture increases, your cost basis on the sale also will create additional capital losses equal to the dollars recaptured.

Let's say you bought an MLP at $40 and have received $8 of distributions that are not taxed and you now sell it for $30. You might think you have a $2 capital loss. What you actually have is $8 in ordinary income and $10 in capital losses.

Now is the time to implement loss harvesting. It can be done without much disturbance to alpha, but you must take care in its execution.

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