Financial Planning

Strategies to Help Clients Around the Wash Sale Rule

BY **ROBERT GORDON** November 6, 2015

This is the time of year when advisors focus on tax-loss harvesting for clients.

Of course, many clients may wish to sell an asset to realize losses, then turn around and repurchase the same fund or security. But the government's wash sale rule gets in the way of that strategy.

However, there are techniques that can be employed for clients when trying to work around the wash sale rule.

A wash sale occurs when an investor sells an asset at a loss and, within 30 days, acquires "substantially identical" property. If a client trips over the wash sale rule, any loss is not currently deductible and actually raises the cost basis of the replacement property.

An example: Mary bought XYZ stock at $50; it is now trading at $35. If she sells at $35, she has a $15 loss. If, two days later, she decides to buy the stock back when XYZ is trading at $37, she will trigger the wash sale rule. Thus, the $15 loss will be suspended and instead she will increase her cost basis in the new shares from $37 to $52.

Losses caught by the wash sale rules are not worthless; they are just not currently deductible.

THE GUIDANCE

The government has given us some guidance on what they consider "substantially identical."

Some clients may believe that a call option on a stock would not be substantially identical to holding the stock. Indeed, call options are measured by delta to discern how similar to the stock they are.

As an example, an at-the-money call is thought to have a delta of 50. In other words, it is predicted that, for every dollar the stock moves, the option will move only 50 cents. This is certainly not identical, right?

However, the government states that the sale of an equity and the purchase of a call option on that equity does actually trigger a wash sale. Ironically selling a call for a loss and then buying the underlying stock does not.

So, if Mary bought XYZ stock for $50 and sold at $35, she would have a $15 loss. If, within 30 days, she bought a call option on XYZ, she would flunk the wash sale test. This is true no matter what call option she buys.

But this penalty can be turned around and used to a client's benefit.

A partner at Deloitte suggested to us a three-step process to take a loss while not substantially disturbing alpha.

Step 1: Sell XYZ for a $15 loss.
Step 2: Buy the call option for $3.
Step 3: Buy back the stock.
This stock purchase has no wash sale penalty because, by purchasing the call, the wash sale rule has already been triggered and the penalty assessed (adjusting upwards the cost basis in the call options). Now the client can own the stock again and hold a call option worth $3, which has an $18 cost basis. The client can sell the call and reap the $15 loss.

Thus, the wash sale penalty has been used to the client's advantage.

Obviously, the order in which these trades are executed is very important; it might even be best not to buy the stock back until the next day, in order to avoid any possible confusion.

HARVESTING ETF LOSSES

This same penalty for call buying can also be handy for clients with unrealized losses in an index-related ETF. Of course, the same strategy outlined above can be followed, but there is an even easier way to harvest the loss, with even less distortion to alpha.

Exchange-traded index options are taxed differently than exchange-traded options on equities, and similarly to futures contracts on the same indices. Internal Revenue Code Section 1256 contracts are marked-to-market on December 31 of each year. Unlike any other financial product, taxpayers are forced to recognize unrealized gains (or losses) without closing the position.

When Section 1256 was put into place, Congressional tax writers concluded that this yearly taxation of futures (and index options) meant that all profits on these contracts would be taxed as short-term. To assuage that concern, Congress declared that Section 1256 contracts would therefore be taxed as if 60% of any gains or losses would be long-term, and only the other 40% of any gains or losses would be taxed as short-term.

Now, let's combine the call buying wash sale rule and the taxation of Section 1256 contracts to harvest losses on an indexed ETF without disturbing alpha.

Step 1: Sell the ETF and realize a loss.
Step 2: Buy an exchange-traded call option on the underlying index; this should cause a wash sale. The deferred loss on the ETF will then increase the cost basis in the index option.
Step 3: Hold the index option over year's end. By holding on December 31, a client will be "forced" to realize the loss on a high-cost basis index option because of Section 1256. Viola, the loss has been harvested, even though the client never left the index.
Caution: OTC index options are NOT Section 1256 contracts.

SELL STOCK, SELL PUT

Lastly, clients can sell their stock for a loss and then sell a put option on those shares.

Example: Mary buys XYZ stock at $50; it is now at $35. Mary sells at $35, realizing a $15 loss. Mary then sells a 31-day put, allowing the buyer to put that stock back to Mary at $40 a share. If the stock stays below $40, Mary gets her shares back. Is this a wash sale?

In a put sale, the government will declare a wash sale when the put position is substantially identical to the stock – that is, when there is a high likelihood that the put will be exercised (unlike the call purchase rule that damns any call purchase).

Most tax practitioners would have no issue if Mary sells an out-of-the-money put, a slight caution if Mary sells an at-the-money put and a genuine concern if the put is in-the-money, with concern growing as the put gets deeper and deeper in the money.

The rules of exchange-traded options can certainly seem complex, but they are worth learning to use to a client's advantage.