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How the Wash-Sale Rule Can Trip Investors

Violating the 30-day rule can destroy tax savings you seek from selling losers.

By Jeff Brown, Contributor |Nov. 6, 2017, at 9:39 a.m.

Year-end investing moves can pay off nicely at tax time the next spring, but can also trip you up.

Take the wash-sale rule. Running afoul of it can destroy your tax savings from selling losers. But understanding it will let you claim those losses and avoid missing investment gains by sitting on the sidelines.

Some experts say the matter is especially pertinent today because investors are hungry for tax savings but eager to stay in the rising stock market.

"Harvesting losses is only effective if the investor understands the wash-sale rules and the timing of when a new position can be opened after realizing a loss," says Brandon Blitzer, manager of Marcum, an accounting firm in Melville, New York.

It sounds arcane and is indeed more likely to apply to active traders than buy-and-hold investors, but the wash-sale rule can affect just about anyone, Blitzer says.

"A wash-sale can affect any investor who is looking to buy and sell securities," Blitzer says. "Individuals to fund managers are affected by the wash-sale rules, particularly one who is constantly trading securities – and thinking they're being smart by taking losses and going back into the stock. Sorry, the loss will be suspended."

With year-end deadlines looming, there's not much time to finesse the system. Here's how the wash-sale rule works.

It starts with the investor's right to claim losses on the federal tax return. Net losses from assets sold for less than was paid are subtracted from net gains on ones sold at a profit. That reduces the profit subject to long- or short-term capital gains tax.

If losses exceed gains, they can be used to reduce ordinary taxable income by up to $3,000 a year. And bigger losses can be "carried forward" to offset gains or income in future years.

So investors are routinely advised at this time of year to look for losers to sell.

The wash-sale rule doesn't matter if you sell stock in a company to be banished from your portfolio forever. The problem is that an investment that has lost money since you purchased it could rebound. Setting the tax issues aside, you might want to buy it today.

The obvious move is to sell to harvest the tax loss and then buy it back to share in future gains. But to prevent investors from gaming the system, the government has the wash-sale rule. It says the tax loss will be disallowed if the investor bought a "substantially identical" asset within 30 days before or after the losing asset was sold.

The 30 days must pass between the two trades. You cannot buy on the 30th day, that's a day too soon.

So selling XYZ Corp. stock and buying it back the same afternoon is definitely out. You might do it for pure investing reasons if news hit after you sold and you thought the stock would soar. But the tax benefit of selling would be lost.

But the term "substantially identical" provides some wiggle room. If you can't repurchase XYZ, maybe you could buy another stock, fund or exchange-traded fund that will rise in tandem with XYZ – another oil driller or car maker likely to react to the same market conditions, for example.

Experts warn that the asset you buy cannot be an identical twin to the one you sell, even if it has a different name or ticker symbol. You cannot sell XYZ and at the same time buy XYZ options contracts. Nor can you replace a Standard & Poor's 500 index fund with another company's fund tracking the same index. The two are, for wash-sale purposes, identical.

This is what makes it so difficult to tiptoe through the wash-sale minefield.

"At the end of November, we run a wash-sale analysis to figure out what securities have wash-sales on them and help plan which holdings with losses could be liquidated in a tax-efficient manner," Blitzer says.

He recalls a client who sold a losing stock near the end of the year to harvest a loss, then bought it back after New Year's, thinking the 30-day limit would not span two different tax years. That was wrong, and the loss was disallowed.

"As a tax advisor helping with compliance, this is not something you want to explain to someone who has lost money but for tax purposes has generated taxable income due to a timing difference," Blitzer says.

Also forbidden is selling a loser in a taxable account and then buying it in a tax-favored account like an IRA or 401(k). The rule still applies, though it is not a factor if purchase and sale are both in tax-favored accounts, since there's no tax saving from selling the loser, anyway.

Rick Henderson of Atlanta Financial in Atlanta says investors who have more than one separately managed account, which leave buy-and-sell decisions to a manager, can run into trouble if one manager sells and another buys the same security. "With SMA investing, the portfolio is separated into different sleeves, and given to professional money managers to pick the stocks and other securities that are in each sleeve," he says. "Each sleeve is managed according to its stated investment mandate."

But if the right hand doesn't know what the left hand is doing, the investor could have an ugly surprise at tax time.

Picking the right replacement asset after selling a loser takes serious attention, Henderson says. That's why experts say the process should not wait until the last minute.

"Typically, when selling a mutual fund for tax loss purposes, I will replace it with a different mutual fund with the same investment objective, or an ETF that tracks a benchmark that is similar to the mutual fund's investment objective," Henderson says. "At that time, I will enter into our system the date that we should trade back into the (original) mutual fund once the wash-sale period has expired."

A wash-sale violation can generally be avoided if the two trades involve an actively managed fund and exchange-traded fund tracking the same type of security, Henderson says.

"ETFs have made this much easier to do," he says. "There is so much choice, and the ease of the transactions is very helpful as well."