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A year-end opportunity to wash your dirty stocks: Harvesting losses with wash sales

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The Rub:

The Internal Revenue Code Section 165(a) permits deductions for any loss sustained during the taxable year and not compensated for by insurance or otherwise. The broad language of Section 165 seemingly allows deductions for almost any type of loss. Logically, the language has of this Section has resulted in abuse, causing Congress to respond by creating limitations on the deductibility of losses. One of the deductions that Congress has disallowed is the deduction for losses resulting from wash sales of stock or securities.

Wash sales are transactions under Internal Revenue Code Section 1091 that occur when a taxpayer sells a stock or securities for a loss and then acquires "substantially identical" replacement stock or securities within a period of time that begins 30 days before the date of the sale and ends 30 days following the date of the sale. If such a sale and repurchase occurs, the loss from the original sale may not be deducted. But it is not necessarily lost forever. Section 1091 defers the loss rather than eliminating it. The non-deductible loss from the sale of the original stock is added to the cost basis of the replacement stock, and becomes applicable when the replacement stock is sold.

The following illustrates how the basis adjustment is applied to the replacement stock:

Joe Market purchases ABC stock on March 1, 2008 for $80,000. Mr. Market sells that ABC stock exactly one year later on March 1, 2009 for $60,000. He reports a $20,000 long term capital loss. Mr. Market then purchases replacement ABC stock on March 15, 2009 for $50,000 and turns around and sell is on April 1, 2009 for $55,000. This is a short term capital gain of $5,000. Mr. Market has a $20,000 long term capital loss and a $5,000 short term capital gain. But if these stocks are substantially similar then a loss cannot be taken for the replacement stock purchased within 30 days of the sale of the original stock. Section 1091(a) applies the wash sale rule to disallow the loss.

But no need to frown or grimace, there is a basis adjustment permitted for the replacement stock. The $20,000 disallowed loss may be added to the cost basis of the replacement stock. The replacement stock now has a cost basis of $70,000 (original purchase price of $50,000 plus $20,000 disallowed loss). Additionally, the holding period includes the period the taxpayer held the original "washed" stock. So selling the later purchased stock on April 1, 2009, Mr. Market is afforded long-term capital loss treatment. Oh Joy!

Note that the wash sale rule does not apply to losses incurred in a taxpayer's trade or business. Humbug for the securities dealer

More Rules:

A wash sale occurs if stock is sold at a loss and substantially identical stock is purchased within 30 days before or after the sale. The key in calculating the period is determining the date when the stock was sold or the trade date if using a broker. It is also important to note that the wash sale rule is violated if dividends are reinvested by a mutual fund within the wash sale period.

One key issue in wash sales is what constitutes "substantially identical." There is not a clear answer or standard by which to evaluate this requirement, but there are some key principles to apply in making this determination. Stocks issued by companies in the same industry are generally not substantially identical if the issuers are different, even if the two issuers are engaged in the same industry and their securities respond to the same market effects. Stocks will not be found to be substantially identical if the new stock is so different that the taxpayer is not placed in an economic situation equivalent to his economic situation prior to the sale of the stocks.

Wash Sales and IRAs:

Revenue Ruling 2008-5 states that the wash sale rules cannot be applied to prevent capital loss treatment for a taxpayer that sold securities in a private account at a loss and then later repurchased the securities in an IRA. These securities were deemed to be substantially identical and the taxpayer was found to exercise dominion and control over both accounts. A unique part of this ruling is that Section 1091 was used as a shield and a sword. The Service ruled that Section 1091(a) denied the capital loss on the sale and Section 1091(d) would not be applied to increase the basis in the new security. This made the loss permanent. But, it is not such a negative Ruling because increasing the basis in the IRA is not beneficial because distributions from IRAs are taxed at ordinary income

rates irrespective of basis.

Creative Approaches:

Note that as an around, one could simply sell stock (or a mutual fund, which is subject to the same wash sale rules) immediately invest in a comparable index or exchange traded fund (ETF) and then buy the same stock or mutual fund 31 days later to avoid the time restrictions. This would result in a capital loss to use against later future capital gains permitting one to stay in the same market during the 30-day wash sale window. ■

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