Year End Strategies To Avoid Wash Sale Tax Issues

Tax year 2011 was an “eye opening” experience for many traders when brokerages began reporting cost basis on stocks to the IRS instead of only the total gross proceeds amount as they did in the past. The law changes also required brokerages to report “wash sales” on stocks (which will be expanded to include other asset classes over time), and in many case the brokerage software generating the results was creating erroneous or incomplete reports. Also as a part of the new law, the Schedule D form was revised and a new reporting form (Form 8949) was implemented. These changes now make the reporting for active traders far more difficult than prior years. Here at TradeMatcher.com we ended up assisting many new clients. A surprising number of those new clients were completely unaware of the Wash Sale Rule and the potentially devastating consequences it can have.

In some cases the Wash Sale Rule will have only minimal consequences, deferring some small amount of losses into the next tax year. However, in some rather common trading patterns, the consequences will be very harmful to an uninformed trader. For instance, many traders move in and out of only a few securities over and over during the year. In that type of trading pattern, a trader can have a losing trading year where he or she experienced large loss amounts, but if that trader holds a position across year end and there have been many disallowed loss items the result can be tragic. **Specifically, that trader can suffer a large real economic loss, yet for tax purposes show a large gain for which the IRS will still expect to receive a tax payment.**

Our firm actually saw enough of those situations last year to warrant publishing this year end letter to help guide active traders with a pair of strategies designed to prevent this unfortunate situation. In practice it usually proves difficult to track every single transaction as it occurs to make sure there is a compliance and avoidance of wash sale consequences with the trade. Therefore, the most common need is instead to employ a strategy where one need not track continuously, but where one can still avoid negative tax consequences. Here are two year end methods which fit this need:

Each strategy involves **Two Steps!**

Strategy One = “Flat Different”

1. Be “flat” on the last trading day of the year, that is, hold no open trades or positions across the year end; and
2. Don’t trade anything in January you traded in December. This includes options on any underlying securities or substantially similar securities as mentioned below.

Alternative Strategy Two = “Flat Vacation”

1. Close all positions and be “flat” the last trading day of November;
2. Do not trade during December, take a complete trading holiday.

Both parts of each strategy are required! For instance, if you are not “flat,” a position you hold across the year end may be carrying a tax adjusted basis unbeknownst to you if there was a wash sale during the year and some actual loss you sustained was disallowed and rolled into the position held. Rule 2 in each case is to keep you from reentering a position within 30 days of a position which closed at a loss.

If you can not follow one of these strategies, then the only means by which you can be sure you will not have loss amounts disallowed in the current year and pushed into the future is to track every position close and avoid trading in:

1) the same security which closed at a loss for 31 days;
2) an option in any underlying security which closed at a loss for at least 31 days; or
3) a "substantially similar security" to the one which closed at a loss for 31 days. (However, one problem with this last "prong" is that the IRS has not defined what it considers substantially similar.)

An especially useful side benefit of using one of the TradeMatcher year end strategies outlined above is that the brokerage 1099 report can be easily checked (and there were indeed a great many errors in the 1099 reporting for tax year 2011) because a "straight match" without calculating wash sales would generate the exact same gain or loss results as the wash sale calculated results in those cases. This error checking can be particularly important because 2011 demonstrated many instances where the brokerage reports were plainly erroneous and the brokerage accounting methodologies are neither published nor transparent.

So again, we highly recommend, if at all possible, you adopt one of the two year end strategies outlined above unless you qualify and have adopted Mart To Market accounting. While there can indeed be many many wash sales in your trading throughout the trading year, adopting one of these strategies will allow you to know that loss amounts actually incurred in a year will stay within the tax year at issue and are not deferred and rolled into an adjusted basis in a position carried across year end.

Note, if you have a tax year other than the calendar year, these strategies would need to be adjusted to take into account your actual tax year. If you would like to discuss these options further, please feel free to give us a call.

Two Additional Important Rules To Avoid More Problems With Wash Sales

1) If you trade in multiple accounts, avoid trading the same securities in both accounts or options in a security you are trading in another account. Otherwise you may end up with cross account wash sale issues which you must report and your reporting will be at variance with your brokerage 1099 reporting and will require an explanatory note to ward off IRS inquiries.

2) You should avoid trading in securities or options on securities in both a regular account AND in an IRA account. Wash Sale issues can arise between a those accounts as well and this is particularly dangerous because it can result in not simply a deferral of the loss amount but a permanent disallowance.

Please remember this is published as only a short informational letter. We would be happy to discuss these items in detail for your personal situation by phone and point you to the controlling statutes and regulations if necessary.