



Prospective Wash Sales

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White Paper

Abstract: When employing a tax-aware portfolio management strategy or managing assets for a tax-averse client, data on prospective wash sales can be used for decision support as part of an execution management platform. This paper uses multiple examples to illustrate a process for identifying prospective wash sales.

Prospective wash sales fall under two broad categories: (1) those that occur due to new positions disallowing realized losses, and (2) those that occur due to disposition of open lots with unrealized losses. Examples are provided for both of these categories.

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INTRODUCTION

The rules for wash sales are specified by I.R.C. § 1091(a):

“DISALLOWANCE OF LOSS DEDUCTION. IN THE CASE OF ANY LOSS CLAIMED TO HAVE BEEN SUSTAINED FROM ANY SALE OR OTHER DISPOSITION OF SHARES OF STOCK OR SECURITIES WHERE IT APPEARS THAT, WITHIN A PERIOD BEGINNING 30 DAYS BEFORE THE DATE OF SUCH SALE OR DISPOSITION AND ENDING 30 DAYS AFTER SUCH DATE, THE TAXPAYER HAS ACQUIRED (BY PURCHASE OR BY AN EXCHANGE ON WHICH THE ENTIRE AMOUNT OF GAIN OR LOSS WAS RECOGNIZED BY LAW), OR HAS ENTERED INTO A CONTRACT OR OPTION SO TO ACQUIRE, SUBSTANTIALLY IDENTICAL STOCK OR SECURITIES, THEN NO DEDUCTION SHALL BE ALLOWED UNDER SECTION 165 UNLESS THE TAXPAYER IS A DEALER IN STOCK OR SECURITIES AND THE LOSS IS SUSTAINED IN A TRANSACTION MADE IN THE ORDINARY COURSE OF SUCH BUSINESS..”

A wash sale is generally described as selling stock at a loss, and buying substantially identical securities within 30 days before or after the sale.

There are three consequences to executing a wash sale:

1. You are not allowed to claim the loss on your sale.
2. Your disallowed loss is added to the basis of the replacement security.
3. Your holding period for the replacement security includes the holding period of the security you sold.

This paper focuses on the first consequence. The realized loss that is disallowed can have a big impact upon the decision-making process used in tax-aware investment strategies. While staying entirely within both the spirit and the letter of the tax code, a savvy manager can extract the maximum tax benefit for his clients so that the taxable gains of his clients' portfolios are substantially less than the economic gains. However, in order to accomplish this, it is necessary to systematically and frequently analyze and re-analyze the structure of the portfolio in order to determine which transactions will or will not lead to positive or negative taxable events.

THE ISSUES

Two types of events can result in a prospective wash sale. The first event (**Type A**) is the creation of a new tax lot that serves as a replacement for a previously realized (but not disallowed) loss. The second event (**Type B**) is the relief of a tax lot that results in a superficial loss, which because of the pre-existence of a candidate replacement lot, will automatically be disallowed.

Type A occurs when a loss has been realized on a retired tax lot and that loss occurred no more than 30 days prior to your date-of-analysis (DoA). When Type A occurs, closed short positions and long positions must be handled differently since short positions use settle date and long positions use trade date to calculate the offset. In addition, chained wash sales can result in lots that appear to have a realized gain but are in fact carrying realized losses, and this must also be considered.

Any reporting for this type of prospective wash sale must detail three things: (1) the number of shares that can be washed, (2) the disallowed loss per share, and (3) the total prospective disallowed loss.

Type B occurs when a pair of long positions or a pair of short positions exists and one holds an unrealized loss and the other was created less than or equal to 30 days prior to the date-of-analysis. Adjustments must be considered for prior wash sales that could affect the tax lot date of the candidate replacement trade. Adjustments must also be made for assumed settle date on shorts. Finally, chained events can also affect the candidacy of both the prospective wash sale and the replacement trade.

Type B trades must be closely examined for the following two conditions: (1) when more than two lots exist in the same direction, the same candidate replacement trade cannot be indicated for more than a single prospective wash sale unless, of course, this is a deliberate decision on the part of the portfolio manager. In other words, only one of the pair can be a wash sale; they cannot both wash each other (2) when a prospective wash sale is identified, it is critical to ascertain whether or not the prospective replacement

trade is already being used as the replacement trade in another wash sale entirely outside the scope of the original pair ('double-booking').

Any reporting for this type of prospective wash sale must detail four things: (1) the number of shares in the open lot that shows an unrealized loss, (2) the unrealized loss per share, (3) the total prospective disallowed loss, and (4) identification of the candidate open replacement lot.

Chaining

Chaining affects both Type A and Type B prospective wash sales. Chaining is the result of a consecutive series of Buy-Sell-Buy scenarios (Buy-Sell-Buy-Sell-Buy). There is no limit to the number of potential trades in a single chain. Chaining becomes especially complex when the cost adjustment to the original replacement Buy creates a subsequent wash sale. This occurs because the cost basis of the replacement Buy is reduced by a sufficient amount to cause a subsequent sale to be a loss instead of a gain. This scenario creates additional replacement Buys, whose holding periods must be adjusted according to the method chosen.

Chaining impacts the prospective wash sales detection process because each candidate event must not only be considered to generate a new wash sale, but may also become a link in an existing chain of wash sales.

EXAMPLES

TYPE A

The following situation is a basic Type A Long Scenario. Date-of-Analysis is 6/10/2011.

Example 1

Buy, then Sell at a loss. Date-of-Analysis is 6/10/2011.

Example 1		TD	Price	Quantity
Buy	ABC	6/01/2011	100	2,000
Sell	ABC	6/10/2011	90	(2,000)

Result: We have a Type A prospective wash sale. The PWS (prospective wash sale) should be reported every TRADING day up through July 10th. The PWS should detail 2,000 shares of ABC with a PDA (prospective disallowed amount) of \$20,000.

Example 2

Short, then Cover at a loss. Date-of-Analysis is 6/15/2011.

Example 2		TD	SD	Price	Quantity
Short	XYZ	6/01/2011	6/06/2011	100	2,000
Cover	XYZ	6/10/2011	6/15/2011	110	1,500

Result: We have a Type A prospective wash sale. Again, the PWS should be reported EVERY trading day within the period of interest, but the period of interest does not expire until 7/15/2011--a full 5 days later than the long scenario.

Example 3

Chained Long Scenario. Date-of-Analysis is 7/26/2011.

Example 3		TD	Price	Quantity
Buy	PQR	6/01/2011	100	1,000
Sell	PQR	6/10/2011	80	1,000
Buy	PQR	6/21/2011	85	1,000
Sell	PQR	7/26/2011	95	1,000

Result: We have a Type A prospective wash sale. Even though the DoA is July 26th and the loss occurred on June 10th and there are more than 30 days between the two dates, there is still a PWS. This is because the loss that occurred on June 10th would be disallowed by the replacement on June 21st, causing a cost basis adjustment to the tax lot acquired on June 21. This adjustment of \$20 per share is enough to cause the July 26 disposition to be considered a loss and therefore causes a Type-A event to be active until August 25th of 2011. The PDA is \$10 per share or \$10,000 total for all 1,000 shares. The PDA is calculated as the original disallowed loss (\$20 per share) netted against the book gain on the second disposition (\$10 per share).

Example 4

Two Buys, then double retirement, one lot gain, one lot loss. Date-of-Analysis is 6/10/2011.

Example 4		TD	Price	Quantity
Buy	ABC	6/01/2011	90	1,000
Buy	ABC	6/10/2011	105	1,000
Sell	ABC	6/10/2011	100	(2,000)

Result: We have a Type A prospective wash sale. Although the Sell shows an aggregate gain on the position of \$5,000, the individual lots must both be tracked. The lot that demonstrates a \$5 loss must be considered a PWS for 30 days following its disposition (July 10th). However, the amount of the PDA is \$5,000 across one hundred shares.

TYPE B

Example 1

Two buys, one with unrealized loss. Date-of-Analysis is 6/13/2011.

Example 1		TD	Price	Quantity
Buy	ABC	6/01/2011	90	1,000
Buy	ABC	6/10/2011	105	1,000
Price	ABC	6/13/2011	100	

Result: We have a Type B prospective wash sale. The second of the two lots holds an unrealized loss of \$5,000. If that lot is disposed of on DoA of June 13th, the first lot (\$90 Buy) will be considered a replacement trade and any loss as a result of the disposition will be disallowed. This will continue up until July 1st. On July 2nd, the \$90 lot's trade date will be more than 30 days prior to the DoA and the PWS will no longer pose a threat.

Example 2

Double Short. Date-of-Analysis is 6/13/2011.

Example 2		TD	SD	Price	Quantity
Short	XYZ	6/01/2011	6/06/2011	90	1,000
Short	XYZ	6/10/2011	6/15/2011	105	1,000
Price	XYZ	6/13/2011		100	

Result: Again, we have a Type-B prospective wash sale. The first lot is now the candidate PWS as it holds the unrealized loss on the DoA of (\$10,000). Should this lot be disposed of at market price, the realized loss will be disallowed and the \$105 Short lot will become the replacement. Also note that this PWS will be active until July 16th, which is the settlement date of the replacement trade adjusted 30 days forward.

Example 3

Chained Long Scenario. Date-of-Analysis is 8/01/2011.

Example 3		TD	Price	Quantity
Buy	PQR	6/01/2011	100	1,000
Sell	PQR	6/10/2011	80	1,000
Buy	PQR	6/21/2011	85	2,000
Buy	PQR	7/26/2011	95	1,000
Price	PQR	8/1/2011	100	

Result: We have a Type B prospective wash sale. At first glance, it might appear that both open lots carry an unrealized gain and therefore are immune from consideration as prospective wash sales. However, we do in fact have a PWS because of a special series of events. The chained effect of the earlier loss of \$20 per share on the first disposition causes the 2,000 share purchase to be broken into two sub lots. The sub lot creation occurs because the replacement lot is larger than the original lot tagged with the disallowed loss. The \$85 Buy must therefore be considered as two 1,000 share sub lots. The first sub lot will be considered a 1,000 Buy at \$105 and a tax lot date of 6/1/2011¹. The second sub lot retains the original date, cost basis of \$85 and tax lot date of

¹ The exact tax lot date used for the replacement trade can be selected using multiple mechanisms. These mechanisms are discussed in another G2 white paper: "Holding Period Adjustment Methods for Wash Sales," available at G2's **Cost Basis Advisory Page** www.g2systemsllc.com/costbasisadvisorypage

6/21/2011. For our purposes, this means there are in fact three open sub lots for consideration. Only the one with the cost of \$105 is a candidate PWS as it is the only one of the three with an unrealized loss. It might appear that either of the other two sub lots could be the candidate replacement trade and therefore the \$85 lot conforms to the IRS guidelines of selecting the replacement in FIFO order. However, the \$85 sub lot cannot serve as a replacement for a loss on a sub lot that belongs to the same parent lot². Therefore, only the \$95 Buy can operate as the replacement. The PDA is \$5,000 and the final DoA for which it will register is 8/25/2011.

SUMMARY

This paper discusses how to detect the existence of wash sales before they occur. Data on prospective wash sales is desirable for any portfolio manager who wishes to extract the maximum tax benefit for his clients. Identifying prospective wash sales is a highly complex process and requires a thorough understanding of I.R.C. § 1091(a). It also requires that you have in place a mechanism for detecting general wash sales so that replacements are not ‘double-booked.’

This white paper is part of a series that provides tips and analyzes issues related to cost basis reporting requirements for financial services firms. Launched in July 2011, G2’s white paper series examines the challenges firms encounter when tackling the complex process of identifying and analyzing wash sales and other tax events. For more information or additional

² § 1.1091-1(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

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