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What is a wash sale?

Often, capital losses can serve to offset capital gains. However, this is not always the case. For instance, losses are disallowed on wash sales. A wash sale occurs when you sell a security at a loss and acquire the same or a substantially identical security within 30 days of the sale (before or after).

Example(s): Assume you own 100 shares of X and 100 shares of Y. You sell X for a gain of $1,000 and sell Y for a loss of $1,000. You did this so you wouldn't have to pay tax on the gain. The next day, you repurchase your Y shares. The sale of the Y shares will be treated as a wash sale, and your loss on such sale is disallowed. If you had delayed your repurchase of Y for 31 days, the loss would have been allowed. However, you are exposed to some market risk by establishing your original position at such a later date.

Substantially identical securities

What is a substantially identical security?
A substantially identical security is one that is, for all practical purposes, the same as the security that you sold. Factors in considering whether stocks or securities are substantially similar include the interest rate, asset value, conditions of redemption or retirement and maturity dates. In addition, purchase contracts, "in the money puts," calls, rights and short sales trigger the wash sale rule.

Stocks and securities that are not substantially identical
Generally, stocks of different companies are not substantially identical even if the companies are within the same industry.

Example(s): Say you own 100 shares of X and 100 shares of Y. You sell X for a gain of $1,000 and sell Y for a loss of $1,000. You did this so you wouldn't have to pay tax on the gain. The next day, you purchase shares of Z with the proceeds from your sale of Y. Z is in the same industry group as Y, it has a similar price/earnings ratio and it pays a similar dividend. Your loss is allowed because Z shares are not considered substantially identical to Y shares.

Generally, bonds are not considered substantially identical if they are substantially different in relation to any material feature, or if they are substantially dissimilar after considering all the material differences as a whole. The following are not considered material features: (a) different issue dates, (b) registered (rather than bearer) status and (c) different interest payment dates. The maturity date, however, may be material. For instance, an additional six months added to a bond with a one-year maturity is probably material, while an additional six months added to a 20-year bond is probably not. The redemption dates for a callable bond are analyzed in a similar fashion.

Example(s): You own a $1,000 bond of X and $1,000 bond of Y. You sell the bond of X for a gain of $100 and sell the bond of Y for a loss of $100. You did this so you wouldn't have to pay tax on the gain. The next day, you purchase a bond of Z with the proceeds from your sale of Y. The Z bond has the same coupon (interest) rate, the same risk rating and the same maturity date. Z is probably substantially identical to Y. If it is, your loss is disallowed.

Example(s): Assume, instead, that Z would come due in one year and Y's maturity date is in 20 years. In this case, Z is probably not substantially identical, and the loss will probably be allowed.

Transactions within the wash sale rule

The following transactions generally fall within the wash rule, assuming the 30-day period applies:

- The acquisition of the same stock or security
- The purchase of an option to buy the same or substantially identical stock or security
- Warrants, calls and other purchase contracts
- Short sales that produce a loss

- The sale of an “in the money” put — if it is likely that the put will be exercised
- The purchase of the same or substantially identical stock or security through contracts to buy on a when-issued basis
- The exercise of a pre-existing subscription right to purchase the same or substantially identical stock or security
- The repurchase of the same or substantially identical stock or security within the seller’s traditional or Roth IRA

Exceptions to the wash sale rule

As mentioned earlier, the wash sale rule generally limits losses incurred within 30 days of an acquisition of the same or substantially identical stocks or securities. It is important to note, however, that the acquisition of a stock or security by a tax-free exchange, by way of inheritance, or through a gift does not invoke the rule.

Example(s): Assume you own 100 shares of X and 100 shares of Y. You sell X for a gain of $1,000. You sell Y for a loss of $1,000. You did this so you wouldn’t have to pay tax on the gain. The next day, your father gives you 100 Y shares. The acquisition of the Y shares is not within the wash sale loss limitation. Your loss is allowed.

Note, also, that the wash sale rule does not apply to losses sustained in the ordinary course of your trade or business.

What is the relevant period of time for wash sales?

The wash sale rule covers purchases made 30 days before or 30 days after a loss transaction. Be aware that the 30-day limitation period continues after the close of the tax year.

Example(s): Assume you make the following transactions in X stock:

December 15, Year 1	Buy 100 shares
December 30, Year 1	Sell 200 shares at a loss
January 15, Year 2	Buy 100 shares

Example(s): In this example, both the first and second purchases are within 30 days before or after the sale of X stock at a loss. Therefore, the losses on the sale of X stock are disallowed. Note that the Year 1 loss is disallowed, in part, because of purchases made in Year 2.

What are the wash sale ordering rules?

In general

If you buy and sell at different times or in different amounts, certain ordering rules will apply. The wash sale rule is applied to stock or securities according to the order of the dispositions causing the losses, beginning with the earliest loss. This means that the first loss must be dealt with fully before any subsequent loss. If losses occur on the same day and the order is not readily ascertainable, you then consider the order of acquisition.

When you sell more than you acquire

If the amount of the stocks or securities acquired during the proscribed period is less than the amount sold at a loss, the loss is disallowed only to the extent of the securities acquired. The remaining loss is deductible.

Example(s): Assume you make the following transactions in X stock:

July 1, Year 1	Buy 200 shares
December 15, Year 1	Buy 100 shares
December 30, Year 1	Sell 200 shares (purchased 7/1/1) at a loss
January 15, Year 2	Buy 50 shares

Example(s): In this example, both the second and third purchases are within 30 days before or after the sale of X stock at a loss. Therefore, the loss from the sale of 150 of the shares is disallowed. The loss on the sale of 50 shares is allowed.

When you acquire more than you sell

When you acquire more than you sell, the loss is disallowed in its entirety.

Example(s): Assume you make the following transactions in X stock:

July 1, Year 1	Buy 200 shares
December 15, Year 1	Buy 100 shares
December 30, Year 1	Sell 200 shares (purchased 7/1/1) at a loss
January 15, Year 2	Buy 150 shares

Example(s): In this example, both the second and third purchases are within 30 days before or after the sale of X stock at a loss. Therefore, the loss is completely disallowed.

What happens to disallowed losses?

In general

Disallowed losses are added to the cost basis of the stock or securities, the purchase of which caused disallowance of the loss. If you buy and sell at different times or in different amounts, ordering rules will apply.

Example(s): Say you own 100 shares of X and 100 shares of Y. You sell X for a gain of $1,000 and sell Y for a loss of $1,000. You did this so you wouldn't have to pay tax on the gain. The next day, you repurchase 100 shares of Y for $5 per share, or $500. Your loss on the sale of the Y shares is disallowed. The basis of the newly acquired Y shares equals the cost of those shares plus the disallowed loss, or $500 (cost) plus $1,000 (loss). The new Y shares have a basis of $1,500.

When you sell more than you acquire

To determine which stocks or securities receive a basis adjustment, the loss is matched to the acquired securities in the order of acquisition.

Example(s): Assume you make the following transactions in X stock:

July 1, Year 1	Buy 200 shares
December 15, Year 1	Buy 100 shares
December 30, Year 1	Sell 200 shares (purchased 7/1/1) at a loss
January 15, Year 2	Buy 50 shares

Example(s): In this example, both the second and third purchases are within 30 days before or after the sale of X stock at a loss. Therefore, the loss from the sale of 150 of the shares is disallowed. The loss on the sale of 50 shares is allowed. The disallowed loss is added to the bases of the 150 shares purchased on December 15, Year 1 and January 15, Year 2.

When you acquire more than you sell

To determine which stocks or securities receive a basis adjustment, the loss is matched to the acquired securities in the order of acquisition.

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July 1, Year 1	Buy 200 shares
December 15, Year 1	Buy 100 shares
December 30, Year 1	Sell 200 shares (purchased 7/1/1) at a loss

January 15, Year 2	Buy 150 shares

Example(s): In this example, both the second and third purchases are within 30 days before or after the sale of X stock at a loss. Therefore, the loss is completely disallowed.

Example(s): The bases of the shares purchased December 15, Year 1 are adjusted first. Then, 100 of the 150 shares purchased January 15, Year 2 are adjusted. The remaining 50 shares have a cost basis.