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Wash Sales:
Why They Happen and How to Handle Them

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Wash Sales: Why They Happen and How to Handle Them

Jeremy Milleson
Senior Investment Strategist

In periods of elevated volatility such as the fourth quarter of 2018—when we saw the largest quarterly decline in the US market, as measured by the S&P 500®, since the third quarter of 2011—investors have many opportunities to harvest losses. Preserving tax benefits by avoiding wash-sale violations becomes even more important during these periods.

Parametric tries to avoid wash sales altogether whenever possible. However, there are occasional circumstances that make wash sales unavoidable. It's important to understand why they occur and why they aren't necessarily a negative. This paper covers why wash sales occur in accounts, their impact on portfolios, and how to minimize violations.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

How does a wash sale impact a portfolio?

The IRS designed its wash-sale rule to prevent taxpayers from claiming a loss on the sale of a stock if they purchase comparable replacement shares within 30 days before or after the sale. If a wash sale occurs in a portfolio, the IRS disallows the losses and adjusts the basis of the replacement shares upward by the amount of the disallowance. The losses aren't necessarily lost because of this adjustment; they're just delayed until the investor can sell the replacement shares in the future.

What causes wash sales in client accounts?

The most common reason for wash sales to appear in Parametric Custom Core® accounts is that a portfolio has a large contribution or withdrawal after a recent loss harvest. In the case of a contribution during the wash-sale period, our portfolio managers may buy back some names that were recently sold at a loss, causing a wash-sale rule violation.

It's important to understand why a portfolio manager may purposefully generate these wash-sale violations. Each time a manager makes a trade, they simultaneously minimize the tracking to the benchmark and maximize the tax benefit. When a large contribution is made during the wash-sale period, the manager wants to make sure the portfolio continues to track the benchmark by limiting underweights in the larger benchmark names. For example, if we sold a portion of Microsoft to generate losses, we'd buy back Microsoft if there's a large contribution, since it's one of the largest weights in the benchmark.

When a manager buys back previously sold positions during the wash-sale period, this creates a wash-sale violation. The IRS would disallow some of the losses and adjust the basis of the replacement shares, reducing the potential realized gains when or if the manager sells the shares in the future. Using the previous example, the losses we realized selling Microsoft would be disallowed, and the cost basis of the replacement shares would rise by the amount of losses that were disallowed. The loss would be deferred until we sell the replacement shares.

Figure 1: Example of a wash-sale rule violation triggered by a contribution following a loss-harvesting trade

	Date	Shares	Price
Buy	January 1	100	$100.00
Sell	June 1	50	$92.00
Buy	June 15	100	$92.00

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In this example, after an initial purchase of 100 shares on January 1, we harvest 50 shares on June 1 for a loss of $400 ($8 loss per share multiplied by 50 shares). Due to a large contribution into the account two weeks later, we repurchase 100 shares of the security.[1] This purchase triggers a wash-sale violation. The $400 loss is disallowed, and the cost basis is added to the securities purchased on June 15. The example transaction in figure 1 shows the purchase triggering a wash-sale violation 15 days after the sale, even though the sale happened more than 30 days after the original purchase. It's important to remember that violations occur if a purchase takes place within 30 days before and 30 days after a sale.

[1] For smaller contributions, we design Parametric systems to avoid this type of wash sale. For contributions of 20% or greater, the portfolio manager must weigh the costs of mistracking against the costs of the wash sale and choose accordingly.

Violations may also occur if there's a substantial withdrawal during the wash-sale period of a recently loss-harvested account. When losses are realized in a portfolio, the manager sells a basket of securities and purchases replacement securities simultaneously. For the securities that were just purchased, a wash-sale violation occurs when we sell the same security to fund the withdrawal. Losses realized in selling the security would therefore cause a wash-sale violation, disallowing at least a portion of the losses and adjusting the basis of the remaining shares.

Figure 2: Example of a wash-sale rule violation triggered by a withdrawal following a loss-harvesting trade

	Date	Shares	Price
Buy	January 1	100	$100.00
Buy	June 1	10	$95.00
Sell	June 15	50	$90.00

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In our second example, after an initial purchase of 100 shares on January 1, we purchase an additional 10 shares on June 1. We may have decided to purchase these shares to improve tracking error in the context of a loss-harvesting trade. The large client withdrawal on June 15 results in the sale of 50 shares of the security on June 15. The sale appears to be a $500 loss ($10 loss per share multiplied by 50 shares).[2] However, this loss is partially disallowed because of the 10 shares purchased on June 1.[3] The disallowed loss is added to the cost basis of the shares purchased on June 1, which creates a future tax-loss harvesting opportunity.

How does Parametric minimize wash-sale violations?

Once we sell a position at a loss or purchase a new lot, we place restrictions on the positions in the portfolio to prevent violations. Clients with linked portfolios will see wash-sale restrictions applied to all linked accounts. Once we trade an account for loss harvesting, we typically won't trade it again until it's out of the wash-sale period. However, as described in the prior examples, it's not uncommon for large contributions or withdrawals to trigger a wash sale. It's also important to keep in mind that while the losses are temporarily disallowed, the cost basis is retained, which can result in a future tax-loss harvesting opportunity.

Conclusion

Amid higher volatility and increased opportunity for loss harvesting, avoiding wash-sale violations to preserve realized losses is important. While we can avoid most wash sales, there are times when wash-sale violations may occur as part of regular portfolio management. We work to minimize both the frequency and impact of wash-sale violations to give our clients the freedom to purchase and sell securities without restrictions.

[2] This example assumes HIFO (highest in, first out) accounting.

[3] We technically purchased 10 replacement shares, so the loss on 10 shares of the June 15 sale would be disallowed. Of the total $500 loss, $100 ($10 per loss multiplied by 10 shares) would be disallowed and this loss would be added to the cost basis of the shares purchased on June 1.

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