WELLS FARGO **Advisors**

Understanding wash sales

Be aware of IRS requirements when selling investments to establish a tax loss

It's not uncommon, especially when there's market volatility, to find your portfolio includes investments that have decreased in value since you bought them but appear to have promising long-term potential. When this happens, you may want to claim the loss on that year's tax return but continue to be invested in the security. A strategy to consider is selling your investment to establish the tax loss and purchasing an equivalent investment in the same security. This can work; however, due to the IRS's wash sale rule, you have to be very careful.

When you sell an investment at a loss, the IRS lets you deduct the loss from other capital gains you might have and your taxable income. If you want to continue to be invested in the security, you can purchase the same investment either before or after you sell the original investment. However, if you do this, the IRS's wash sale rule requires you to accept the risk of being out of the investment for 30 days either before or after the date when the transaction occurs creating the loss. That's a total of 61 days, as shown below. This means you can't purchase the new investment immediately after you make the sale establishing the loss and then claim the loss on that year's return.

Wash sale rule time requirement

New position purchase date	← 30 days →	Original position sale date	← 30 days →	New position purchase date

More specifically, the IRS says a wash sale occurs when a taxpayer sells or trades a stock or security at a loss and within 30 days before or after the sale:

1. Buys substantially identical stock or securities

2. Acquires substantially identical stock or securities in a fully taxable trade

3. Acquires an option contract to buy a substantially identical stock or securities

4. Acquires substantially identical stock or security for their traditional or Roth IRA

How the rule works

For example, you own 100 XYZ Company shares you bought for $10,000 that are now worth $7,350. You'd like to claim the $2,650 loss on your tax return; however, you really believe in XYZ Company and want to be invested in it for the long term.

Let's say you decide you want to sell your position on June 1 to establish the tax loss. To avoid violating the wash sale rule, you can purchase 100 XYZ Company shares on either:

- May 1 or earlier (a strategy known as "doubling up")
- July 2 or later

On the other hand, you could invest in a different company in the same line of business as XYZ Company. You can do this at any time as long as what you purchase doesn't run afoul of any of the stipulations listed above.

What happens when there's a wash sale?

When a wash sale occurs, the rule prohibits deducting the loss on that year's tax return. However, you may be entitled to a tax benefit at a future date because the loss is added to the new security's cost basis, which will reduce your gain or increase your loss (depending on how XYZ Company stock performs) if you sell it in the future. The date of the new purchase also changes to the date of the previous wash sale.

In our example, assume you sold your original XYZ Company position for $7,350 and purchased a new position for the same amount. But in doing so, a wash sale occurred. As a result, you would not be able to claim the $2,650 loss on that year's tax return. However, the loss would be added to the new position's cost basis, making it $10,000 ($2,650 + $7,350). That would mean you could still enjoy a tax benefit from the loss—just not in the current tax year. If you were able to sell the new security in the future for $12,500, for example, your taxable gain in that year would be only $2,500 ($12,500 – $10,000) rather than $5,150 ($12,500 – $7,350).

Wash sale reporting requirements

The IRS requires financial institutions to monitor and report wash sales for identical security transactions occurring in the same account. However, institutions are **not** required to track replacement shares an investor purchases at another institution or even in another account at the same institution. That means the IRS makes investors responsible for monitoring wash sales across all accounts—including across institutions and among spousal accounts (when filing jointly) and complying with the requirements to compute wash sales.

Treatment of same-day purchases

Take extra care when you purchase the same security in more than one transaction on the same day. You could stumble into a wash sale without even knowing it, as shown in this example:

On August 15, you purchase:

1. 100 shares of XYZ Company for $37 per share at 10 a.m.

2. An additional 100 XYZ Company shares for $39 per share at 11:30 a.m.

On September 6, you sell 100 XYZ Company shares at $35 per share.

This would result in a wash sale because you purchased the identical security in **two separate transactions** on August 15th and sold some of those shares at a loss within 30 days. Therefore, you could not claim the loss on your current year's tax return and the shares purchased at 11:30 a.m.* (the second transaction) would have a new $41 cost basis ($39 paid plus $2 loss).

If the purchase on August 15th had been one order for 200 shares that required two trades to fill, the sale would not be a wash sale since there wouldn't have been a separate second purchase within the 30-day period.

Contact your Financial Advisor for more information

If you have questions about the wash sale rule, please contact your Financial Advisor.

** Based on using first-in-first-out (FIFO) lot identification, which is the default unless specifically identified otherwise.*

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