Wash sales and active management

By Jerry C. Wagner
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It's that time of year. That's right—tax preparation season. One of the tax topics that seems to elicit the most questions is the mysterious issue of wash sales. Hopefully, this article will not only dispel the mystery but also answer the questions.

What is a wash sale?

Under the Internal Revenue Code, a wash sale occurs when an investor sells a security and then repurchases a substantially identical security within 30 days of the date of the sale.

What is the effect of a wash sale?

Wash sales defer an investor's ability to take a loss resulting from a sale of the investment. So if an investor sells an investment on February 1 at a loss of $3 and then buys the same investment back on February 15, the loss from that sale is not recognized (deducted from other income). Recognition of the loss would be delayed until a new sale occurs that is not within 30 days of a purchase (before or after).

Why is a wash sale treated this way?

Before the wash-sale rule entered the Internal Revenue Code, investors could artificially generate a capital loss by simply selling a stock that they had a loss on and buying it back a short time later. This allowed investors to reduce their taxable income by taking advantage of volatility at a time of their choosing, even though they had no intention of not remaining invested in the security. The wash-sale rule sought to eliminate what was deemed a tax-avoidance scheme.

Why a wash sale is not as bad as you might think

First, the wash-sale rule only applies to losses taken outside of a tax-deferred vehicle. It does not apply to trades made within an IRA, 401(k), 403(b), or other qualified plans. It also does not apply to trades within a variable annuity (VA) or variable universal life policy.

Even if the trade is outside one of these deferred income vehicles,

1. the use of the loss is not lost to the investor but is just deferred until the investor has a non-wash-sale trade;
2. if that occurs within the same year, there is no impact on the investor's taxes at all; and
3. when the loss is deferred, the deferred loss is added to the cost of the investment, so that when there is a sale of the stock in a non-wash-sale trade, any gain is reduced by the amount of the earlier wash-sale loss. Similarly, if there is a loss, it is increased by the amount of the wash-sale loss foregone.

How do wash sales impact active management?

The likelihood of a wash sale depends on how frequently your manager trades. Many strategies trade essentially identical securities on a daily or weekly basis. Such strategies will by definition generate wash sales.

FPI strategies where this is the case are WP Income Builder, Sector Index Rotation, Managed Income Aggressive, Political Seasonality Index (all daily trading), and Fusion (weekly trading). The wash-sales treatment is the trade-off for using more frequent trading to seek downside protection and more frequent profit opportunities.

In addition, tactical strategies, which move into and out of a single index fund or asset class, can have a whipsaw trade in which they buy and then reverse course in a short period. While this rarely happens in many of the tactical strategies (Volatility Adjusted NASDAQ, Self-adjusting Trend Following, Systematic Advantage, Trivantage, and Classic), contrarian or mean-reversion strategies (Contrarian S&P Trading, S&P Tactical Patterns, and TVA Gold) are designed to have short-term trades, and this will occur with some regularity.

Four ways to avoid wash sales at Flexible Plan Investments

1. *Trade the strategies previously mentioned first in your qualified accounts.* None of these trades will be classified as a wash sale.

2. *Trade these strategies solely in a variable annuity (VA).* Jefferson National Monument Advisor is an especially good vehicle for this since they charge only $20 a month—no matter how big or small the account. So it's $20 on a $1,000 account and also on a $1,000,000 account. It is truly one of the best deals on Wall Street—buying tax deferral for just $20 per month. And almost all of our strategies are available on Jefferson National.

   I've heard some advisers say that this approach ignores the fact that distributions taken are subject to ordinary income-tax treatment, and they want to avoid such treatment. But with a VA you defer taxation on trades that occur before distribution *and* avoid dealing with wash sales. If you held the strategies outside of the VA in a taxable account, you would neither defer nor avoid, regardless of when you took money out of the account. Instead, you would have to deal with taxation and wash sales yearly. It's especially great to be able to avoid both for just $20 per month.

3. *Use our QFC strategies.* All of the frequent trading with our QFC strategies is done within the mutual funds. Trades *within* a mutual fund are not subject to the wash-sale rule. Reallocations of assets within the QFC strategies generally occur with a one-month-plus trading cycle, so they are not subject to wash-sale treatment. However, Classic and our new Political Seasonality Index and Systematic Advantage QFC strategies are subject to the whipsaw possibility previously discussed. The other QFC strategies have little chance of a wash sale—and they have a low, low advisory fee—a win-win!

4. *Restrict your strategies to our less-traded strategies.* Our monthly trend-following strategies, such as Evolution Plus, Market Leaders, Lifetime Evolution, All-Weather, any

of our Evolution specialty strategies, and our Principled Investing strategies (Faith Focused Investing and For A Better World) trade no more frequently than monthly. In this same vein, A Better Buy & Hold and Low Volatility/Rising Dividends seek to have no short-term trades.

I know that any day now I will receive a call from a client, adviser, or accountant wanting to know about these wash sales showing up in a client account. Hopefully, with this explanation and a little planning, this will be the last year that happens for our readers.*

Jerry C. Wagner
President

*While Mr. Wagner was a practicing tax attorney, Flexible Plan Investments does not provide tax advice. Readers are encouraged to seek the counsel of their own qualified tax accountant or attorney on these matters.

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