

## Harvest losses without hurting alpha

The time to consider wash sale strategies for the 2009 tax year is before Thanksgiving

By Robert N. Gordon

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Most money managers who strive to be tax-efficient harvest losses year-round. A 2001 study by First Quadrant LP, a global institutional money manager, found that continual loss harvesting can add 80 basis points annually to an indexed investor's after-tax return.

Most individuals, however, focus on the issue only at the end of the year, hoping to offset realized gains with harvested losses. Although not optimal, this is better than not harvesting losses at all, and time is running out for 2009.

Before doing your fall harvesting, here is a quick recap of the wash sale rules: If an investor sells for a loss and within 30 days acquires "substantially identical" property, the loss won't be currently deductible but instead will be added to the investor's cost basis on the recently acquired property. Note that the wash sale rules apply only to securities.

Tax authorities devised the wash sale rules to discourage investors from harvesting losses and immediately repurchasing the property with the loss. A 31-day window was deemed sufficient to prove that the investor was truly out of the stock.

After the wash sale rules were put in place, investors tried to replicate the loss position with options or other derivatives. Some investors sold shares at a loss and then sold in-the-money puts on the same shares.

The government, in a 1985 ruling, decided that the sale of a put causes a wash sale if there is a "substantial likelihood" that the put will be exercised, although it has given no guidance as to what "substantial likelihood" entails. Most practitioners feel that selling out-of-the money puts is allowed, selling at-the-money puts is probably allowed, and selling in-the-money puts may be a problem.

In the past, investors sold underwater shares and then bought call options on the stock because call buying didn't trigger the wash sale rules. Now the purchase of any call triggers the wash sale rules whether the call is "substantially identical" or not.

A deep in-the-money call probably is substantially identical, but an out-of-the money call (even though not substantially identical) still flunks the wash sale rules.

Why the urgency to focus on this now, and not in December? Because the strategy we deem to be optimum must be implemented when there are more than 31 days before the end of the year. As a result, we usually suggest that this become a pre-Thanksgiving exercise.

Start with the double-up strategy known to most advisers.

Here, if you have an unrealized loss on 1,000 shares, you buy another 1,000 shares and hold 2,000 shares for 31 days. After this minimum time has elapsed, you sell 1,000 shares but identify the shares sold as the lot bought long ago at a much higher price, thus realizing the loss.

Exiting the extra lot of shares also must be done this year.

The obvious hitch: to achieve the loss harvest, you must own twice as many shares as you would like to own. We are advised that you can remove the risk of the second lot of shares without disturbing the ability to take the loss currently.

You do that by buying the extra shares, then simultaneously selling a call and buying a put, each with the same strike price and expiration. The option positions together neutralize the risk of holding the second lot of 1,000 shares.

What do you do after Thanksgiving if you couldn't accomplish those trades? There are solutions, but most affect returns.

Call options on individual equities can be used in harvesting losses, though replacing an equity with its call option is specifically caught by the wash sale rules. But those rules can be used to your advantage.

Here's how. Assume you bought a stock at \$60 that is now at \$42. First, sell the stock and take an \$18 loss.

Then, buy a call option with, say, a strike price of \$50 for \$1. The wash sale rules deny the current deduction of the \$18 loss by increasing the cost basis of your call from \$1 to \$19.

Next, buy the stock you sold. You already triggered the wash sale rules and took the penalty, so tax attorneys tell us this repurchase doesn't interfere with the loss harvesting.

Finally, sell the call. If you sell it this year for the same \$1 you paid, you will realize an \$18 loss that should be currently deductible.

As you can see, there are ways to work through the wash sale rules. By coordinating with your clients and their tax advisers early, you can help investors lower their tax bills without deviating from their desired investment exposures.

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