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The American Taxpayer Relief Act of 2012 raised the rates on both short-term and long-term capital gains. The rates in this article do not reflect these changes.

Wash sales and index investing

Some lessons from a robust loss-harvesting season

By Robert N. Gordon

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Wash sale rules prohibit an investor from recognizing a loss for tax purposes if securities are sold and "substantially identical" securities are purchased within 31 days. We were recently reminded that these rules apply only to securities, not to gold, currencies or other non-securities assets.

But how do the rules apply to index funds?

Because so many investors in broadly based index funds had losses large enough to crystallize as tax losses last year, we have been asked repeatedly if the sale of one index fund and the immediate purchase of another trigger the wash sale rules.

We in turn have queried our tax advisers and found a consensus: Such transactions do flunk the wash sale rules, though there has been no specific guidance from the government on the matter.

Although the sale of an Standard & Poor's 500 stock index fund and the immediate repurchase of another such fund seem to cause concern, switching between two funds that invest in the market without index specificity didn't seem to raise red flags. Although two index funds based on the same index may not be identical (they could have different sponsors, fees and possibly even different legal structures), our tax experts expressed concern because similar index funds, whether in the form of a conventional mutual fund or an exchange traded fund, are contractually obligated to invest in the same particular index.

So what is the best course for an investor who wants to realize a loss on an index fund and not miss the next move up? Such an investor can use the tax rules to his or her advantage and sell a losing index fund and immediately purchase a listed index option on that very same index.

This forces the investor to realize their loss at yearend.

Allow me to explain how the interaction of the wash sale rules with the relevant tax rules on publicly traded index options affords an investor the ability to stay invested while realizing his or her loss.

Step 1: Sell the ETF (or index fund) and realize a loss.

As an example, let's assume that the investor has a $30 loss a share on the Standard & Poor's Depository Receipt ETF that tracks the S&P 500.

Step 2: Buy a listed call option on the S&P 500. Let's assume that this purchase is considered a wash sale by the government. The penalty is that the loss ($30 a share in our case) isn't currently deductible but instead is added to the cost basis of the call option purchased. If we pay $4 for the call, its cost basis is increased to $34. (Note: If the purchase of the call didn't trigger the wash sale, then the $30 loss would be allowed without any further trading).

Investors must take care to buy a publicly traded option on the index so that the transaction is subject to IRC Section 1256, which requires that contracts be marked to market Dec. 31.

The mark-to-market should trigger the realization of the investor's loss for tax purposes. (Over-the-counter index options aren't IRC Section 1256 contracts).

Also, make sure that the call option is on the index itself, not the ETF.

We are of the belief that an option on an ETF, as opposed to an option on the index, wouldn't be an IRC Section 1256 contract.

Any mark-to-market gain or loss is taxed as 60% long term and 40% short term (causing a blended tax rate of 23%).

This 60/40 treatment would be an extra benefit to those with unrealized long-term losses and a detriment to those with unrealized short-term losses because the original dollar of losses will now be realized as 60 cents of long-term loss and 40 cents of short-term loss.

In short, by closely following the taxation rules on wash sales and Section 1256 contracts, an investor can harvest losses on an ETF or open-end index fund without disturbing their investment returns.

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