

What is a Wash Sale?

We're not talking about laundry

Say you hold an investment in a taxable account and you sell it for a loss. Can you use that loss to lower your taxes?

Yes — unless you purchase that same security (or one that is substantially identical) either 30 days before or after you sold that asset. If you did, the sale is called a “Wash Sale” and it provides no tax break — at least not this year.

The Wash Sale rule closes a tax loophole: Say you invest \$10,000 in shares of XYZ Corporation and the value falls to \$7,000. You want to keep your shares because you believe the stock will rise, but you’d also like to lower your taxes. So you sell your shares and immediately re-buy them. This way, you figure, you get to continue owning your shares

— and you’ve collected a \$3,000 tax deduction at the same time!

Sorry, but you’ve just run afoul of the Wash Sale rule. You can’t take a deduction for such sales, but you must still report them on your Schedule D, noting them as a “Wash Sale.” (Your original cost basis remains intact, so you’ll eventually get the tax break you’re seeking.)

If the Wash Sale rule disallows losses incurred, why not simply avoid transactions that trigger them? Well, sometimes they are simply unavoidable — especially when you engage in periodic rebalancing as part of a comprehensive asset allocation strategy. ▶

An example of the reporting of a Wash Sale

The two lines cancel each other out, so that the loss noted on Line 2 does not result in any tax savings on this year’s tax return.

Substitute Schedule D-1						Page 2
Name(s) shown on return				Your social security number		
Part II Long-Term Capital Gains and Losses -- Assets Held More Than One Year						
(a) Description of property	(b) Date acquired	(c) Date sold	(d) Sales price	(e) Cost or other basis	(f) Gain or (loss)	
ICF 672.000 wash	12/9/2008	11/21/2008	\$0.00	(\$11,682.92)	\$11,682.92	
ICF 672.000 sh.	11/21/2007	12/9/2008	\$27,200.65	\$38,883.57	(\$11,682.92)	
9 Totals. Add the amounts in column (d). Also, combine the amounts in column (f). Enter here and on Schedule D, line 9			\$27,200.65		\$0.00	

That's where EMAP comes in. As you know, rebalancing is an integral part of the Edelman Managed Asset Program®. Without this crucial function, assets in your portfolio could become overweighted or underweighted — potentially leading to higher risks and/or lower performance. To reduce those problems, Edelman Financial Services (EFS) periodically sells shares of one asset and buy shares of another asset. Ordinarily, rebalances occur infrequently, but due to the volatility experienced in 2008, there may have been occasions where EFS needed to repurchase shares of an asset that had been sold within 30 days — triggering the Wash Sale rule.

While fully aware the rule was being triggered, trades were executed anyway. Why? Because the motivation wasn't tax savings but to realign your assets in a manner consistent with your asset allocation. If your account is in need of rebalancing, then EMAP will rebalance. There's no harm tax-wise, and the results of 2008 showed that EMAP's rebalancing efforts helped to reduce your investment risks and improve your

returns. To be sure, tax considerations are important, but they should never outweigh more important objectives of your investment portfolio.

To summarize:

1. Rebalancing, which can reduce investment risk and improve performance, can also cause a Wash Sale.
2. The disallowed loss under a Wash Sale is added back to the cost of the security. This will reduce your future taxable gains and thus lower your future taxes.
3. The benefits of rebalancing can outweigh the nuisance of reporting Wash Sales. Never make investment decisions primarily based on taxes.
4. The complexity of reporting Wash Sales demonstrates that you should always work with a tax advisor in the preparation of your tax return.

If you have any questions, please contact your advisor.