The Capital Gains Tax Traps Even Savvy Investors Miss

Capital gains taxes are often treated as a simple matter: sell an asset, report the gain, and pay the tax. But in practice, the rules governing how those gains are calculated and taxed aren't always simple. And by the time mistakes are discovered, you could be looking at an unexpected tax bill, or worse, a letter from the IRS.

Seemingly routine decisions, especially when made across multiple accounts or without tax oversight, can create compound errors that impact both tax liability and audit risk.

In this article, we'll explore four capital gains tax traps that frequently go unnoticed. While none of these are particularly obscure, each can undermine even well-intentioned strategies if not properly managed.

Ignoring the wash sale rule - and the portfolio domino effect

One of the most frequently misunderstood rules in capital gains planning is the wash sale rule.

Under IRS guidelines, if you sell a security at a loss and repurchase the same or a "substantially identical" security within 30 days before or after the sale, the loss is disallowed for tax purposes. Instead, the disallowed loss is added to the cost basis of the replacement shares, effectively deferring the loss until a future sale.

While this rule may seem simple in isolation, it often causes issues in practice. You could unintentionally trigger a wash sale by:

- Reinvesting dividends automatically into the same security,
- Repurchasing the security in a different account, such as an IRA, 401(k), or spousal brokerage account, or
- Allowing a portfolio to be rebalanced by a robo-advisor or model-driven platform

And once a wash sale is triggered, the associated basis adjustment can create discrepancies that carry forward into future tax years, especially if the position is sold again and the basis is misreported.

Please note that a wash sale and related IRA re-purchase, for instance, could result in permanently disallowed losses. The rules governing wash sales and certain retirement accounts, in particular, can be nuanced, so it's important to consult a tax advisor when these situations arise.

Imagine selling 100 shares of a stock at a loss, with the goal of realizing the loss at year-end. But, unbeknownst to you, a standing automatic investment in your IRA purchases 5 shares of the same stock just 3 days later. While only 5% of the original position was replaced, the wash sale rule applies proportionally - meaning 5% of the loss could be disallowed.

Wash sales aren't illegal, nor are they always a problem. But failing to track them correctly introduces the risk of overreporting gains, underreporting losses, or both.

Incorrect or incomplete cost basis tracking

Cost basis is the foundation of capital gains taxation. Yet errors in calculating or reporting basis remain one of the most frequent causes of unexpected tax liability.

Brokerage accounts

With brokerage accounts, investors commonly rely on custodians to track basis. But those records may omit key adjustments, like:

- Wash sale disallowances across multiple accounts,
- Dividend reinvestments over time,
- Transfers between custodians, and
- Tax lot selection methods, which determine which shares are sold when an investor holds multiple lots of the same security.

Inherited assets receive a step-up in basis to fair market value as of the decedent's date of death in most cases, but that adjustment often requires supporting documentation or a formal appraisal, and brokerages may default to a placeholder if information is missing. On the other hand, gifted assets retain the donor's original basis, which can become a problem if the recipient is unaware of embedded gains.

Real property

Cost basis is even more of an issue when it comes to real estate. Capital improvements, for instance, increase basis and reduce gain on sales - but investors often fail to track and document those adjustments. Depreciation deductions, especially for rental or commercial properties, can lower basis and may be subject to recapture at ordinary income rates upon sale, depending on the type of property.

The absence of routine tracking for these adjustments means errors can easily go unnoticed until a property is sold. And inaccurate basis records can lead to significant tax challenges, particularly when dealing with high-value properties or assets held for decades.

The bottom line is that basis needs to be properly tracked and documented, or it can lead to unintended tax consequences. And when property is acquired through inheritance, gifts, or partial ownership transfers, basis needs to be adjusted with documentation to support the adjustments.

Underutilizing tax-loss harvesting and strategic gifting

Tax-loss harvesting and strategic gifting are two of the most effective tools for managing capital gains exposure over time. Yet many investors fail to leverage either fully.

Tax-loss harvesting

Tax-loss harvesting involves selling investments at a loss to offset realized capital gains elsewhere in the portfolio. While the concept is straightforward, many investors only consider it in years of market volatility or treat it as an afterthought. In reality, loss harvesting is most effective when deployed proactively throughout the year and across all taxable holdings.

Losses can be used to offset capital gains on a dollar-for-dollar basis. If capital losses exceed gains in a given year, up to $3,000 of net loss can be deducted against ordinary income. Any remaining unused losses can be carried forward indefinitely and applied in future tax years.

To implement this strategy effectively, monitor your taxable portfolios throughout the year, not just in the fourth quarter, and maintain a running record of realized gains and losses. Also, maintain a capital loss carryforward schedule, which can typically be found on Schedule D of the prior year's tax return.

Tax-loss harvesting can also extend beyond equities. You can also use losses to offset gains from non-portfolio assets, such as the sale of appreciated real estate, business interests, or collectibles. In these cases, coordinating the timing of losses and gains within the same tax year is key, particularly when a large transaction is planned.

And don't forget the wash sale rule. Remember, purchasing the same or a substantially identical security within 30 days will disallow the loss and adjust the basis of the new shares.

Strategic gifting

Gifting appreciated assets can also reduce capital gains exposure. However, the tax treatment depends heavily on who receives the gift and how the transaction is executed.

Assets gifted to an individual during your life retain their original basis in the hands of the recipient. So you might avoid a gain by gifting, but the recipient could face a significant tax bill when they sell the asset, based on the original purchase price. And the value of the gift will be applied against your lifetime gift and estate tax exemption, unless it falls within the annual exclusion amount. For these reasons, gifting appreciated assets during life is generally not tax efficient from an income tax standpoint unless the recipient is in a substantially lower tax bracket. Even then, the long-term tax outcome depends on when and how the asset is ultimately liquidated.

Donating appreciated securities directly to a qualified charity enables you to avoid realizing the gain and potentially claim a charitable deduction equal to the fair market value. This deduction is subject to AGI limitations and holding period rules, though. This strategy is particularly effective for investors subject to the Net Investment Income Tax, because it not only avoids triggering capital gains, but may also reduce the income used to calculate the surtax.

Overlooking state-level capital gains taxes

While much attention is given to federal capital gains rates, the impact of state tax policy is often overlooked.

Unlike the federal system, where long-term capital gains are taxed at preferential rates, many states make no such distinction. Instead, capital gains are taxed as ordinary income, subject to the state's top marginal rate.

In total, more than 40 states levy some form of tax on capital gains, each with its own rules regarding deductions, exemptions, and treatment of asset classes. State tax auditors are increasingly focused on high-income earners and capital transactions, particularly in states facing revenue pressure. Given the variance in state-level tax treatment, location and timing of asset sales can have a significant effect on after-tax outcomes.

The value of precision in capital gains planning

Capital gains tax strategy is often reduced to a discussion of rates and holding periods, but the real complexity lies beneath the surface.

The traps discussed here are not obscure technicalities. In fact, they're mistakes made precisely because they involve familiar actions, like selling, reinvesting, gifting, that are easy to execute but just as easy to mismanage without a tax-aware framework.

Next Step

Of course, this overview is not intended as investment or tax advice, nor is it a comprehensive treatment of all capital gains rules and exceptions. If you need help with capital gains strategies, contact our office. We can help assess your situation in detail and develop a customized approach aligned with your specific goals.

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