Tax-Loss Selling

By Michael Kemp

As we head towards the end of each financial year, talk invariably turns to tax issues. For investors that usually means a discussion about Capital Gains Tax (CGT). This article shows how to minimize your CGT liability without falling foul of Aussie tax laws.

What is a Capital Gain or Loss?
A capital gain or loss is the difference between what you paid for an asset and what you received when you sold it. For tax purposes what you paid includes the costs associated with its acquisition. And what you received is calculated by deducting the costs of disposal from the selling price.

For tax purposes, gains and losses are treated differently. Tax is payable on the gains in the financial year they are crystallized. That is when the shares are sold. Capital losses can be used to offset capital gains, but not other tax liabilities such as income from personal exertion. Hence capital losses can only be recognized if there are capital gains to offset. The good news is you can carry forward unused losses to future tax years.

Reducing Your CGT Liability
So here's the picture. The end of the financial year is looming. In an effort to lower your tax bill you look to reduce the capital gains you need to declare. You've tallied up all your share sales for the year and the gains outweigh the losses (even counting the losses you've been able to carry forward). So you decide to crystallize some more losses by selling the remaining losers out of your share portfolio. That is, shares worth less now than what you paid for them.

You're not alone in this process. Other investors around the country are doing exactly the same thing. This activity carries lots of different names - Tax Loss Selling, Wash Sales, Bed'n'Breakfasting or simply Ditching the Dogs.

But before you reach for your broker's phone number it's important to understand what Aussie tax laws permit.

Tax Laws Covering Wash Sales
Crystalizing a tax loss by selling is not a problem, but what you do after that could be. For example wash sales (the quick sale and repurchase of the same asset to crystalize a paper loss) is definitely not allowed. Some countries define in very clear terms what constitutes a wash sale. For example in the United States you cannot claim a capital loss if the same stock is sold and bought back within 30 days.

Australian tax laws aren't quite as clear as that. For starters we don't have a specific 30-day buy back rule. Instead the Commissioner asks us to interpret the less clear 80-year-old general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act (ITAA)1936. You'll run fowl of the Act if you answer yes to BOTH the following questions:

1. Did you obtain a tax benefit from your activity – a benefit that would not have been available if you hadn't entered into it?

2. Would it be concluded that you entered into the scheme for the sole or dominant purpose of obtaining a tax benefit?

Of course people love to interpret things to suit themselves. And in the absence of specific guidelines this is exactly what they did. Which meant wash sales became very popular. But when too many people start bending the rules the antennas at the ATO go up. In 2008 it issued tax ruling TR 2008/1 which specifically outlawed arrangements where:

"in substance there is no significant change in the taxpayer's economic exposure to, or interest in, the asset, or where that exposure or interest may be reinstated by the taxpayer".

That's tax Commissioner speak for – no wash sales. But a specific time frame still wasn't defined; just don't do it "within a short period". Where the ruling did provide clearer definition was in banning the following arrangements:

- Claiming a tax benefit from selling an asset a short time before buying it back, OR buying the same asset a short time before you sell it.
- Entering into a repurchase agreement with another party (including family members). That is, an agreement to sell it now and buy it back later for a pre-determined price.
- Transfers between yourself and a company or trust in which you have an interest in order to achieve the same economic benefit.
- Using derivatives or financial instruments to achieve the same result.

Avoiding Penalties
A breach of the Act carries penalties of up to 50% of the tax avoided. Penalties also extend to promoters of these arrangements.

In assessing your activity the Tax Commissioner will consider your intent. If it can be shown the dominant purpose of your buying and selling was to turn a paper loss into a tax-usable loss then you are in trouble. This doesn't cover the simple act of selling and then declaring the loss.

Nor do you breach the Act if you buy and sell two different companies within a short time frame, even if they're in a similar line of business. So selling RIO and buying BHP is OK.

Does "Ditching the Dogs" Move the Market?
All this buying and selling raises an obvious question: If lots of people are dumping shares into the market in June does it influence market prices? And does it make sense to jump ahead of the queue and sell earlier to get the best price?

To answer this question let's start with the old stock market adage: "Sell in May and Go Away"". Is it good advice? CXO Advisory Group, a bunch of US investment industry myth busters, looked at it. They studied whether superior returns could be achieved by converting from stocks to bonds in May and being out of the stock market for 6 months every year. The study, which covered a 142-year period ending in 2012, found that the strategy was beaten hands down by good old buy-and-hold. Strike one.

Another possible strategy is to sell when the whole stock market is depressed. The aim is to generate losses which can be then be carried forward to offset gains in future years. It's based on the premise there will be more losing stocks in your portfolio when the general market is down. This sounds mighty like “market timing” to me and that’s something not many punters seem able to do. Strike two.

Finally, a winning stock in one person’s portfolio could represent a loser in another’s. After all whether it’s a winner or a loser doesn’t depend solely on where the share price is now. It also depends on the price it was bought. And since not everyone bought at the same price a company won’t necessarily be dumped “en masse” in any given June. Strike three.

It seems that trying to outsmart the market at tax time is a pretty curly issue. So I’d suggest you don’t let tax considerations be your sole reason for selling. Sell stocks if they disappoint. Hang onto them if they don’t. The government is hell bent on getting the money out of you one way or the other anyway.

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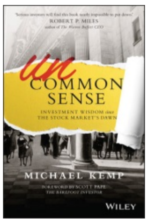

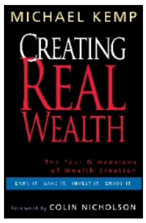

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of “Uncommon Sense”. Published under the Wiley label “Uncommon Sense” delivers a deeply considered and logical approach to the otherwise complex world of investing.