

When washing is a dirty word

A falling sharemarket has prompted the re-emergence of the wash sale as a tax-saving strategy, PETER BOBBIN writes. But beware, it's a strategy fraught with potential legal pitfalls.



AS THE end of the financial year approaches the thinking of many financial planners and brokers turns to bed 'n' breakfasting. Bed 'n' breakfasting involves crystallising paper tax losses and offsetting these against earlier income or capital gains.

There are many reasons to bed 'n' breakfast an investment, especially for those holding paper losses from investment activities in the first half of this year and earlier real taxable gains.

Bed 'n' breakfasting's simplest form is having an investor buy and sell an investment on the same day.

The only problem is that it is illegal. The most common alternative name for bed 'n' breakfasting is a "wash sale". This is also illegal.

The penalties for a wash sale depend on the intent of those who are doing the washing; it is jail for the stockmarket manipulator and tax penalties of at least half of the tax benefit for everyone else.

The first form of a wash sale is rare. It involves a person, directly or indirectly, buying and selling securities, usually in the same transaction, so as to give the market an impression of increased activity. The purpose is to create the expectation that big news is about to come out. With the big news the manipulator hopes to generate a price rise that they can take advantage of. This is illegal.

The second form of a wash sale is also illegal in a tax-law sense. But most people do not know this and, worse, many believe it to be a standard taxation-balancing investment practice.

This form of wash sale involves the selling and buying of securities with the intent of taking an unrealised loss and making it claimable as a tax deduction, or to offset against a capital gain. The goal is to turn a paper loss into a usable tax offset.

The wash sale has been a common year-end tax strategy, although in recent years it has been missing from statements of advice (SOAs), mostly because of the continuously rising market.

From the October 1987 crash to the beginning of this year, the All Ordinaries Index rose 530 per cent. In the past five years alone the S&P/ASX 200 has doubled.

In the first few months of 2008 the market has fallen 23 per cent. This fall has reintroduced appropriate conditions for the tax-saving strategy of the wash sale.

Unfortunately, the strategy does not work. This is the view of the Australian Taxation Office in its first ruling for 2008. Not all ATO rulings are correct and, predictably, the ruling on wash sale arrangements leads to the result that more, not less, tax will be payable. However, in my view, ruling 2008/1 is not only correct, it is both well structured and well written.

The tax illegality of a wash sale is not unique to Australia. In some tax codes, such as those in the United States and Britain, a wash sale involving a security repurchased within 30 days of its sale automatically triggers a disallowance of any tax loss and an adjustment of the tax purchase value of the stock acquired.

The interest of the ATO in wash sales was no doubt encouraged by its March 2007 Federal Court win against Peter Cumins, who sought to wash sale his shareholding in Cash Converters International. It was argued by his counsel that everybody did it.

The court found that argument unacceptable. "The appellant's contention that holders of share portfolios regularly enter into transactions near the end of the financial year is a vague generalisation, and as such is unhelpful," it responded. "There was no evidence put to the tribunal or the court in relation to this proposition or its relevance."

Do the wash sale rules apply to all sale and repurchase transactions? Yes, if the dominant purpose is to turn a paper loss into a tax-usable loss. No, if this is not the dominant purpose. Huh? How does that work?

What the ATO is saying is that if the sale and repurchase was undertaken with the main purpose of securing the offsetting paper loss, then the ATO will apply Part IVA of the *Income Tax Assessment Act 1936* and cancel the tax benefit sought.

Now, before you get too clever with disguising the wash sale, the ATO has considered not only the circumstance of the taxpayer who sells and rebuys, but also where the sale is followed by a repurchase of the original asset in an associated trust or other structure, or what is bought is economically equivalent to, or fungible with, the original asset.

The wash sale tax-benefit cancellation can also apply to a transfer of a paper loss security into a self-managed superannuation fund.

Application of Part IVA is key to the success or failure of tax outcomes from investment portfolio realignments that may look like wash sales. This is where the SOA plays a critical role in condemning or protecting the investor client, as it will likely represent the only chance to clearly identify the dominant purpose.

Part IVA can cancel a tax benefit from a transfer of securities into an SMSF if the primary purpose of making the transfer was to obtain the tax-loss benefit. It cannot if this was not the dominant purpose.

So the first tip in preparing an SOA, which suggests a transaction that may look like a wash sale, is to avoid using the words “wash sale”. This is sound, if simple, advice.

Next, do not use any words that suggest a wash sale or a purpose of securing the tax benefit. Such an SOA will present to the ATO with the evidence of the dominant purpose of securing the tax benefit. This is a necessary element for the operation of Part IVA.

Is it best to keep quiet about the resultant tax loss? If you believe this you obviously have not read the ATO ruling yet. In the ruling the ATO uses the word “counterfactual” 30 times. Always be wary when the ATO uses a word whose meaning you need to look up. But use of this word tells us what is needed: the SOA needs to identify the “anti-counterfactual”.

Identifying the anti-counterfactual requires the financial planner, broker or other adviser to quell their excitement about the resultant tax loss and to identify and document the reasoning for the client undertaking what otherwise looks like a wash sale.

Too often the adviser’s tax excitement colours the presentation of a particular strategy to such a degree that their comments will tax-condemn the investor who may have had no or only a little tax-related motivation. The adviser often sees a clever tax strategy and waxes lyrical over pages of the SOA, but what the investor sees is just the final financial outcome of a more financially secure retirement.

Take, for example, the recommendation to transfer certain paper-loss-exposed securities into an SMSF. The suggestion that this will crystallise an offsetting tax

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loss capable of absorbing an earlier or later tax gain will result in the tax loss being exposed to an ATO Part IVA counterfactual exercise; the tax loss will be lost. This is likely to happen even if the true purpose of the investor is simply to localise all of their investments into their superannuation fund in the pursuit of building the post-age 60 tax-free retirement income stream.

The SOA will have condemned the investor by the adviser’s tax excitement.

The ATO itself points out in its wash sales arrangement ruling that “if the taxpayer disposes of, or deals with, the asset to an associate and the associate benefits in substance from the asset, or there are demonstrable non-tax advantages or objects, whether of a business or family nature, secured under the scheme, subject to the other factors, this would tend against the conclusion as to the dominant purpose such that Part IVA might be expected not to apply”.

The ATO even gives an explanation of this in the fourth example of its ruling. It concedes that it cannot apply Part IVA to what looks like a wash sale because the reason for the transfer by the taxpayer to his family trust was to meet his children’s education needs. On this occasion the taxpayer was advised that he should gift the shares to the trust as a source of further investment capital and to reduce his income tax liability.

Now, before you question whether the law has changed, the ruling is quite clear: it applies both before and after its date of issue.

As the end of the financial year approaches, if you’re thinking of washing, take care to not get too excited – remember the anti-counterfactual. 🌟

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