

PART IVA AND WASH SALE ARRANGEMENTS – WILL IT ALL BECOME CLEAR IN THE WASH?

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This paper concerns the recently released Taxation Ruling TR 2008/1 regarding the application of Part IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) to “wash sale” arrangements. The paper proposes that the Ruling, and the legislation on which it is based (Part IVA of the ITAA 1936), will present problems for investors and advisors due to vagueness and uncertainty. Both Part IVA and the ruling are drafted in very broad, general terms and do not provide the specific guidance and certainty required for taxpayers to be able to confidently interpret and predict which transactions will be covered by the ruling. This is perceived as a serious problem given the number of taxpayers that could be affected by the ruling. The paper covers a brief history of the legislation currently relating to the use of wash sales. It then critically appraises this legislation and the ruling mentioned above in terms of their vagueness and lack of guidance offered to taxpayers and advisors. It discusses possible “solutions” to the problems discussed relating to the ruling and cites the US and Canadian rules concerning wash sales as a possible alternative that could be followed.

I INTRODUCTION

The Australian Taxation Office recently released Taxation Ruling TR 2008/1 regarding the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) to “wash sale” arrangements. A wash sale involves the sale and subsequent repurchase of the same, or substantially the same, asset within a short period of time. The result is that there is effectively no change in the economic exposure of the owner to the asset. The purpose of the transaction is to incur a capital loss which can be used to offset capital gains made in the same, or a subsequent, financial year. The taxpayer thereby offsets the gains but still effectively owns the same asset as they did before the transaction, albeit with a lower cost base than the asset originally had. The ruling also covers transactions where shares are transferred to family members, companies or trusts that are controlled by the same person, again incurring a capital loss without losing economic exposure to the asset.

This paper proposes that the Ruling, and the legislation on which it is based (Part IVA of the ITAA 1936), will present problems for investors and advisors due to vagueness and uncertainty. Both Part IVA and the ruling are drafted in very broad, general terms and do not provide the specific guidance and certainty required for taxpayers. Any ruling covering share dealings will affect many taxpayers, not only large corporations, but salary and wage earners who “dabble” in the stock market. In its *2006 Australian Share Ownership Study*, the ASX found that approximately 7.3

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million people, or 46% of the Australian population aged 18 years or more, participated in the Australian Share Market, either directly via shares or indirectly via a managed fund.¹ Six million people or 38% were direct investors. These numbers are down on the 55% share ownership levels recorded in the 2004 study when Australia had the highest reported level of share ownership in the world.² The 2006 study also showed that shareholders are more active in their investment activities and hold, on average, more companies in their portfolio than in the past. The ruling will therefore affect a large percentage of the taxpaying population, including many “average” salary and wage taxpayers, some of whom would no doubt prepare their own tax return without the help of a tax agent.

One of the biggest problems faced by taxpayers, tax practitioners and tax administrators is when legitimate tax planning crosses the line and becomes tax avoidance.³ This is not helped by the fact that it is difficult to explain why the Commissioner applies Part IVA in some circumstances and not in others. This has led to frustration on the part of taxpayers and advisors who are unable to predict accurately the likely application of Part IVA to transactions.⁴ This paper does not intend to question whether a “true” wash sale transaction should come under the definition of anti-avoidance or is simply a legitimate method of tax planning in light of the way the capital gains tax regime operates. This could be another paper in its own right. Instead the paper assumes that wash sales are a type of tax avoidance and intends to question whether the use of Part IVA provides the best and clearest “solution” to deterring the use of wash sales whilst still allowing for the legitimate buying and selling of securities to take place. The paper will, in particular, concentrate on the sale (to an unrelated party) and then repurchase of the same or substantially the same asset rather than the transferring of assets to related parties. The legitimate sale of shares and then repurchase of the same or similar shares is considered to be something that the “average” taxpayer, even those who do not consult a tax advisor, might consider doing. This paper will investigate the implications of the new ruling and the amount of guidance it offers to these taxpayers.

The first part of the paper will cover a brief history of the legislation currently relating to the use of wash sales. The paper will then critically appraise this legislation and the ruling mentioned above in terms of their vagueness and lack of guidance offered to taxpayers and advisors. It will then discuss possible alternatives to the use of Part IVA and the Ruling and finally will make a recommendation as to an alternative route that could be followed.

II WHY USE WASH SALES?

Before 20 September 1985 Australia did not have a comprehensive scheme for the taxation of capital gains. Certain capital gains were taxable under s 25A (ITAA 1936), which covered profits from the sale of property acquired for the purpose of profit-making by sale or a profit making scheme, and s 26 AAA (ITAA 1936), which

¹ Australian Securities Exchange, *2006 Australian Share Ownership Study* (2006) <www.asx.com.au/media> at 1 November, 2007.

² Australian Securities Exchange, *2004 Australian Share Ownership Study* (2004) <www.asx.com.au/media> at 1 November, 2007.

³ G. T. Pagone, ‘Tax Planning or Tax Avoidance’ (2000) 29, *Australian Tax Review*, 96.

⁴ Graeme Cooper, ‘The Emerging High Court Jurisprudence of Part IVA’ (2006) 9 *The Tax Specialist*, 5.

covered profits on the sales of property held for less than 12 months.⁵ Thus, for the majority of taxpayers who bought shares with the intention of keeping them as an investment there was no need to consider wash sales as the gains made on the sale of the shares were generally not taxable. However once the capital gains provisions were introduced in 1985 net capital gains, as determined by s 102-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), are now included in statutory income under s 6-10 (s 10-5) (ITAA 1997). Under capital gains legislation only net capital gains are included in assessable income. Net capital gains are calculated by subtracting any capital losses made during the current income year from total capital gains and then subtracting any losses from earlier income years. Net capital gains are taxable in the year in which they are realised but net capital losses cannot be used to offset ordinary income from other sources. As capital losses can only be used to offset capital gains, they must be quarantined and carried forward if they exceed the amount of capital gains in any particular year.

The wash sales arrangement offers an attractive option for investors who have made gains during a year and at the same time are carrying unrealised losses on other investments, investments which they still wish to hold. Any taxpayer who has a capital gain during a year is certainly entitled, under the law, to realise any capital losses they are carrying. For example, if a taxpayer sells one parcel of shares and makes a gain and they know they have another parcel where the market value is below their cost base, they are certainly able to sell those shares and offset the loss. It is when they immediately buy back the same shares, as if they never actually wished to sell them in the first place, that a wash sale occurs. The purpose of doing this is to incur the loss whilst continuing to hold the shares. But what happens when a taxpayer sells some shares at a loss with a genuine intention to stop holding the shares and then, at some time after the sale and owing to some unforeseen circumstances, changes their mind about the shares and decides they would like to repurchase them? These are the taxpayers who may be unfairly caught by the new ruling and current legislation which provide little certainty for these taxpayers.

III THE LAW AT THE MOMENT

A Part IVA

The use of wash sales is considered to be a type of tax avoidance by the ATO. In Australia there are several specific anti-avoidance rules in both the ITAA 1997 and the ITAA 1936, for example, Div 165 of the 1997 Act limiting deductibility of company tax losses. There are, however, no specific rules covering the use of wash sales. Their use has generally been covered by Part IVA (ITAA 1936). Part IVA came into operation on 24 June 1981 (before the introduction of capital gains tax) and was introduced as a general anti-avoidance measure.

Part IVA can apply to arrangements entered into after 27 May 1981 and will apply if it can be established that there is a scheme (s 177A), that the taxpayer has obtained a tax benefit (s 177C) and that the scheme was entered into for the purpose of obtaining the tax benefit (s 177D). Part IVA enables the Commissioner to cancel the tax benefit obtained by the taxpayer from such a scheme (s 177F). Penalties can be imposed on the taxpayer under Subdivision 284C of the *Taxation Administration Act, 1953* (Cth) (TAA). For Part IVA to apply the “scheme”, “tax benefit” and “purpose”

⁵ Michael Kobetsky et al, *Income Tax: Text, Materials and Essential Cases* (6th ed, 2006) [8.10].

must all be linked together and interpreted as a whole when determining the final conclusion. For example, whilst a tax benefit may exist, this will not be sufficient for Part IVA to apply unless the dominant purpose of the transaction or scheme was to derive a tax benefit.⁶

The term “scheme” is defined very broadly in s 177A (i) as

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether enforceable or not enforceable, or intended to be enforceable, by legal proceedings and
- (b) any scheme, plan, proposal, action course of action or course of conduct.

The breadth of this definition is obvious and the courts have sought to apply some limitations to help in the interpretation of what constitutes a scheme for Part IVA. In *FCT v Peabody* the High Court held that although the Commissioner had identified a scheme as covering a wide series of transactions he was entitled to rely on a narrower range. This indicated that a broad interpretation of the word “scheme” could apply. However, the High Court found that to constitute a scheme the set of circumstances had to be capable of “standing on their own” without being “robbed of all practical meaning”.⁷ This requirement may no longer be necessary following the decision in *FCT v Hart* where Gummow and Hayne JJ indicated that it was not necessary for the scheme to stand on its own and that the scheme could encompass just the taking of one step.⁸ Although no decision has been made on this point, it would seem that if a scheme can be narrowed down to the taking of the one step that involves a tax benefit then there is no reason to inquire as to the dominant purpose of the scheme as it will always be to obtain a tax benefit. The “scheme” with regard to wash sales is likely to include all the steps involving the sale and repurchase of securities or the transfer of securities to a trust or company.⁹

The second requirement is that a “tax benefit” must have been obtained. The meaning of “tax benefit” is defined in s 177C (1). Originally Part IVA did not cover tax benefits from capital losses. However, s 177C (1) (ba) states that a tax benefit will include

- a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out.

This section relates to schemes entered into after 3 pm on 29 April 1997. The tax benefit obtained in the majority of wash sales is a capital loss that can be used to offset capital gains realised in the same or subsequent years.

The third requirement for Part IVA to apply is that the scheme must have been entered into for the “dominant purpose” of obtaining a tax benefit. S 177D lists eight factors that must be taken into account in determining the “dominant purpose”. These are:

- (i) the manner in which the scheme was entered into or carried out;
- (ii) the form and substance of the scheme;
- (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried;
- (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

⁶ *FCT v Hart* (2004) 55 ATR 712.

⁷ *FCT v Peabody* (1994) 28 ATR 344, 352.

⁸ *FCT v Hart* (2004) 55 ATR 712, [43].

⁹ *Taxation Ruling TR 2008/1*.

- (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
- (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and
- (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi)

This is perhaps the most relevant requirement for the application of Part IVA to wash sales. Each of these eight factors involves an objective finding of fact and involves determining what a “reasonable person” would conclude.¹⁰ Is it possible for the subjective intentions of the party to be taken into account? In *Peabody* the court found that only an objective conclusion can be drawn having regard to the eight factors in s 177D and that no other matters, including the subjective purpose of any relevant person, can be taken into account in drawing the conclusion.¹¹ This objective approach was confirmed by the High Court in *Spotless*.¹² It is only necessary that one of the parties involved in the scheme have a dominant purpose of obtaining a tax benefit. The consideration of the eight factors listed in s 177D requires a balancing of the commercial and tax elements of a transaction.

B Cumins Case

Although there is no specific legislation covering wash sales the Commissioner gave an indication of his thinking with regard to these arrangements in IT 2643.¹³ This ruling stated that it was not possible to give assurance that Part IVA would not apply to ‘wash sale’ arrangements generally.¹⁴ Perhaps more importantly, the recent decision in the *Cumins* case¹⁵ confirms that the Commissioner is willing to apply Part IVA to wash sales.

In this case the taxpayer was the trustee of a discretionary trust (Trust 1) and that trust derived a capital gain from the sale of shares in 1998. The trust owned other shares which it had purchased with funds borrowed from the National Australia Bank. A wholly owned subsidiary of the bank was appointed attorney to deal with the shares and receive dividends. One day after the above mentioned capital gain was made the taxpayer created a second trust (Trust 2) for which he also acted as trustee. On the same day the taxpayer as trustee of Trust 1 sold the shares to Trust 2 effectively selling them to himself. The sale was effected by an unsigned agreement. Trust 2 did not pay for the shares and the bank was not informed of the sale. The sale resulted in a capital loss for Trust 1 which exceeded the capital gain made the day before. The net capital gain of the Trust for the income year that was distributed to the applicant was reduced from \$939 099 to \$139 099.¹⁶

¹⁰ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404, 422.

¹¹ *Peabody v FCT* (1993) 40 FCR 531, 542.

¹² *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404, 413-414.

¹³ *Taxation Ruling No IT2643* covered the sale of shares in companies in liquidation or receivership and has since been withdrawn.

¹⁴ *Ibid* [3].

¹⁵ *Cumins v Commissioner of Taxation* (2007) 66 ATR 57.

¹⁶ *Ibid* [23].

The issues before the court included whether, in the year of income, the applicant in his capacity as trustee of Trust 1 had incurred a capital loss in the sum of \$800 000 under Pt 3-1 (ITAA 1997) and, if so, whether Part IVA (ITAA1936) operated to deem that no part of the capital loss had been incurred.¹⁷ The Tribunal found that the appellant had obtained a tax benefit connected to the scheme identified by the respondent and that a reasonable person would conclude that the sole purpose of the appellant in carrying out the scheme was to obtain the tax benefit and affirmed the respondent's Part IVA determination.¹⁸ Justice Nicholson held that Part IVA may apply even where a scheme is 'genuine or directed at crystallising a loss'; although he noted that in this case no economic loss was suffered and the beneficial ownership of the shares did not change.¹⁹ The Cumins case has obvious implications for the use of wash sales. However, the transaction involved exactly the same shares, occurred one day after the capital gain was made, and was not an actual sale of shares on the open market.

C New Ruling

In 2007 the Commissioner issued Draft Taxation Ruling TR 2007/D7 on the application of Part IVA to 'wash sales' arrangements. This Draft Ruling became Taxation Ruling TR 2008/1 on 16 January 2008. The ruling states that the Commissioner is

concerned with arrangements which have the effect of causing a disposition to happen which enables a taxpayer to incur a loss to offset against a gain already derived, or expected to be derived, in certain circumstances. These being where owing to the manner, substance and timing of the events it may be questioned whether the loss making event is mainly to be explained by reference to the purpose of obtaining a tax benefit from the loss.²⁰

The ruling goes on to list nine examples of when a transaction may be considered a wash sale. These examples cover the sale/repurchase of assets including shares, derivatives and financial instruments. They also cover disposing of assets to a company or trust where the taxpayer controls or influences the company or trust or to family members. The ruling covers taxpayers who obtain a benefit in the form of a capital loss or an allowable deduction (where the asset is on a revenue account). Should Part IVA be found to apply to the wash sale the Commissioner is likely to exercise his powers under section 177F to cancel the tax benefit and determine that the whole or part of the capital loss or allowable deduction was not incurred by the taxpayer during the income year.²¹ The ruling then lists six detailed examples applying the eight factors in section 177D to each example. In four of the six examples the conclusion reached is that the Commissioner is likely to find that Part IVA will apply.

¹⁷ Ibid [15].

¹⁸ Ibid [25].

¹⁹ *Cumins v FCT* (2006) 61 ATR 625, [36-37].

²⁰ *Taxation Ruling TR 2008/1*, [2].

²¹ *Taxation Ruling TR 2008/1*, [14].

IV THE PROBLEM FOR TAXPAYERS AND ADVISORS

A Part IVA

One of the main problems for taxpayers in applying Part IVA is that it does not specifically tell them what the law is with regard to particular transactions but if the transaction is found to be covered by Part IVA then there are penalties involved²². It is drafted so widely that it provides little guidance on whether the Commissioner will apply the Part in particular situations or not. The Courts have also generally failed to provide clear or predictable guidelines to help taxpayers and advisors identify what should be caught by Part IVA.²³ Some researchers have even suggested that General Anti-Avoidance Rules breach the rule of law. Prebble and Prebble believe the rule of law requires that laws be capable of guiding people.²⁴ They must be relatively clear and certain so that people know what is permitted and what is not. General Anti-Avoidance Rules breach this requirement of certainty through their purposeful vagueness.

Perhaps the most difficult aspect of applying Part IVA to wash sales for taxpayers is the “dominant purpose” test. For the Commissioner to conclude there was a “dominant purpose” of obtaining a tax benefit and therefore apply Part IVA to a scheme it is only necessary to apply an objective test using the eight factors listed in s 177D. Sometimes this “dominant purpose” may be obvious in an objective test by a “reasonable person” (such as when there is a simultaneous sell/repurchase transaction of exactly the same security). However, when a period of time has elapsed between the sale and repurchase or when the repurchase involves an asset that is not identical to the original then the dominant purpose may not be as obvious. A taxpayer may have many reasons for repurchasing the same or similar assets after a period of time has elapsed. These reasons could be as varied as a change in fortune of the company whose shares are involved to the advice of an informed family member. For any of these reasons to be taken into account there must be objective evidence (such as the release of improved profit figures) for Part IVA to be found not to apply. Any evidence of the subjective purpose of the taxpayer is irrelevant. This has been concluded in several cases including *FCT v Zoffanies Pty Ltd* where Hill J said:²⁵

It follows that while the conclusion required to be drawn is one that requires consideration of the purpose or dominant purpose of a person, including the taxpayer, that conclusion can not take into account evidence of the actual purpose of a taxpayer or other person, save and except so far as that could be forensically relevant to any one of the matters specifically referred to in s 177D (b) for example, the manner in which the scheme was entered into. None of the eight matters refer to the actual purpose of any person. It also follows that generally, at least, evidence of what may be referred to as the actual or subjective purpose of the taxpayer is irrelevant.

This was again confirmed in *Hart* where their Honours found that statements about why the taxpayers acted as they did do not provide an answer to the question posed in s 177D. They found that the section does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others.²⁶ A taxpayer may feel they

²² *Taxation Administration Act, 1953*, Subdivision 284C.

²³ G. T. Pagone QC, ‘Tax Planning or Tax Avoidance’ (2000) 29 *Australian Tax Review*, 96.

²⁴ Rebecca Prebble and John Prebble, ‘Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach the Rule of Law?’ (Paper presented at the Australian Tax Teachers’ Association Conference, Brisbane, 22-24 January, 2007), 2.

²⁵ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236, [53].

²⁶ *FCT v Hart* (2004) 55 ATR 712.

have a valid reason (other than instigating a wash sale) for repurchasing an asset but unless they can provide objective proof of the reason the Commissioner may still determine that Part IVA applies.

B Taxation Ruling TR 2008/1

The ruling is based on Part IVA so the problems already discussed that relate to this part of the legislation also apply to the ruling. The ruling, however, has problems of its own. Tax rulings are issued by the Commissioner to assist taxpayers and practitioners to apply the tax laws and to fulfill their tax obligations. They provide his opinion as to the interpretation and application of the law and are used by the ATO in fulfilling its role as tax administrator. Two key objectives of the ruling system are to provide certainty and to ensure fairness for taxpayers within the context of the self assessment system.²⁷ The ruling system is therefore meant to provide certainty as to the Commissioner's view of the law and would hopefully put taxpayers and advisors in a position of being clear on how the Commissioner will apply the law to particular situations.

It is in this regard the draft ruling falls short especially concerning its vagueness and lack of "definitions". The ruling could be relevant to any taxpayer who has sold an asset during the year and is contemplating buying some other asset with the proceeds. These taxpayers are offered little "certainty" due to the broad range covered by the terminology used in the ruling. One term which is likely to cause problems appears in the examples of what will be likely to constitute a wash sale. The examples use the term "shortly prior to, at the time of, or shortly after" to describe the time period between the buying and selling of the asset in question.²⁸ The meaning of the term "at the time of" is not considered vague but questions could be raised as to what constitutes "shortly prior to" and "shortly after". Obviously other factors are taken into account when deciding if Part IVA will apply but these terms offer little guidance to taxpayers as to what time frame the Commissioner considers is relevant. If a taxpayer sold shares and bought them back the same day or even within a week a "reasonable person" may consider that to be "shortly after" but what if the taxpayer waits a month, two months or even six months. Will this period of time still be considered "shortly after"?

The detailed examples in the ruling provide little guidance in this respect. One example uses a 24 hour period between the sale and repurchase and states that the price of the stock changed by 1 c during this period – the conclusion being that Part IVA would apply.²⁹ Another example concerns an investor selling shares which are very "volatile" and have gone into "free fall". Three days later he repurchases the shares which have regained some of their credibility and are climbing in price. The overall conclusion is that Part IVA would not apply.³⁰ These two examples are extreme examples and provide little guidance on the period of time the Commissioner would consider to be "shortly" before or after. Although three days is a short period of time, the finding in the second example was due to the change in fortune of the shares and the conclusion as to dominant purpose and had nothing to do with the time period.

²⁷ Diana Scolaro, "Tax Rulings: Opinion or Law? The Need for an Independent 'Rule Maker'" (2006) 16, *Revenue Law Journal*, 1, 108.

²⁸ *Taxation Ruling TR 2008/1*, [4].

²⁹ *Taxation Ruling TR 2008/1*, [26-34].

³⁰ *Taxation Ruling TR 2008/1*, [61-67].

Appendix One to the ruling offers some further guidance on the matter of timing stating that “A significant period of time between the disposal and acquisition would be consistent with the way in which taxpayers usually hold and realise investments”.³¹ However there is no indication of what constitutes a “significant period of time”.

The second vague term concerns the asset itself. The examples use the term “same or substantially the same asset”³² to describe the asset that is the subject of the wash sale. Again, part of this term, the word “same” is not considered vague. However the term “substantially the same” could be open to various interpretations. The ruling attempts to explain the term in paragraph 6 where it states:

An asset is substantially the same as the asset disposed of or dealt with if it is economically equivalent to or fungible with the original asset. An asset is also substantially the same as the original asset if there are immaterial differences between the two assets, such that in substance the assets are economically equivalent.

The ruling mentions, in the examples, that “derivatives or financial instruments that substantially provide continued exposure to the risks and opportunities of the asset”³³ are considered to be the same asset. However it is not clear exactly what assets would be considered “economically equivalent” or “fungible” to other assets?³⁴ Perhaps more guidance in this regard is needed. In their recent joint submission on the draft ruling,³⁵ the professional bodies also point to this vagueness as a problem. They believe that the inclusion of substantially the same assets and derivatives is inappropriate (given that Cumins³⁶ dealt with the same asset) and likely to be impracticable. They recommend that:

The Draft Ruling should provide examples that clarify when an asset will be treated as substantially the same as another. The degree of similarity that is required should be better illustrated. This will be an important issue for investors that may be switching between similar types of investments.³⁷

The actual ruling does attempt to clarify this vagueness slightly compared to the Draft Ruling. The ruling states that shares in a competitor company that carries on a similar business to the original company in question will not constitute substantially the same asset.³⁸ An investor could therefore sell shares in the ANZ Bank and buy Commonwealth Bank shares as these would not be considered substantially the same.

The Commissioner is covering all bases with this ruling by not giving any specific guidance for taxpayers and advisors to follow. The ruling makes generalised statements such as “in the absence of all relevant information, it is not possible to state definitively whether a particular wash sale scheme will attract Part IVA”³⁹ and “An arrangement that achieves similar economic and tax effects through the use of

³¹ *Taxation Ruling TR 2008/1*, [93].

³² *Taxation Ruling TR 2008/1*, [4].

³³ *Taxation Ruling TR 2008/1*, [4].

³⁴ The Macquarie Dictionary defines “fungible” as “of such a nature that one unit or portion may be replaced by another in respect of function, office or use”. So could one bank share be replaced by another bank share or one mining share with another mining share??

³⁵ CPA Australia, the Institute of Chartered Accountants Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia, *Joint Submission on Draft Ruling TR 2007/D7* (2007) <www.taxinstitute.com.au> at 26 September, 2007.

³⁶ *Cumins v Commissioner of Taxation* (2007) 66 ATR 57.

³⁷ CPA Australia, the Institute of Chartered Accountants Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia, see above n 35, 3.

³⁸ *Taxation Ruling TR 2008/1*, [6].

³⁹ *Taxation Ruling TR 2008/1*, [9].

similar techniques to those set out above may also be a wash sale”.⁴⁰ The timing of the release of the ruling, after the Commissioner’s victory in the Cumins case, would seem to indicate that the Commissioner issued the ruling with this case in mind. It is therefore relevant to remember some of the particulars of this case - exactly the same asset was involved (no question of whether it was “substantially the same”), the asset was simply transferred between trusts with no actual change in control or legal ownership, no cash changed hands (it was a paper transaction) and it occurred only one day after a large capital gain was made. Questions should be raised as to whether the ruling is simply addressing this type of mischief or stepping outside the boundaries set in this case.

V SOLUTIONS

A Ruling More Specific

Some of the problems discussed concerning the new ruling could be addressed if the ruling was more specific. More examples are needed to clearly show the Commissioner’s views on what constitutes “shortly” with regard to time and “substantially the same” with regard to the definition of an asset. Of course making the ruling more specific raises a whole new set of problems. The Commissioner issues rulings as a means of expressing his views on particular areas of the law. They are provided to assist taxpayers in light of the self-assessment system. However rulings are not the law.⁴¹ Some would argue that if the Commissioner were to get very specific such as determining an actual set time for “shortly” or compiling a detailed list for “substantially the same” he could be said to be making law and this could be a problem especially if the parameters set are outside the scope of cases such as Cumins. It is not his role to make new laws.

B Specific Legislation

Another possible solution is to legislate specifically against the use of wash sales. The United States has had a “wash sale” provision in the form of section 1091⁴² since 1921. This section provides for the disallowance of the loss on the sale of securities where substantially identical stock has been purchased within thirty days of (before or after) the date of sale. However, perhaps a more relevant comparison can be achieved by considering the legislation in Canada.

Canada has general anti-avoidance legislation similar to Australia. This is contained in Part XVI, section 245 of the Canadian Income Tax Act.⁴³ This section seeks to deny a tax benefit from transactions that are “avoidance transactions”. An avoidance transactions means any transaction (including an arrangement or event) unless the transaction “may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit”.⁴⁴ The section also relates to transactions that are part of a “series of transactions” which would seem to be similar to the Commissioner in Australia being able to identify a part of a transaction as a scheme. Following the Australian experience this section of

⁴⁰ *Taxation Ruling TR 2008/1*, [5].

⁴¹ Scolaro, see above n 27.

⁴² 26 USC Sec 1091

⁴³ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 245.

⁴⁴ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 245 (3) (a).

the legislation would seemingly be considered enough to disallow the use of wash sale transactions however Canada also has specific legislation covering these transactions⁴⁵ and does not simply rely on their anti-avoidance legislation to deter the use of wash sales. Taxpayers cannot recognise a capital loss that is a “superficial loss”, defined in Section 54 as

the taxpayer’s loss from the disposition of a particular property where

(a) during the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer acquires a property (in this definition referred to as the “substituted property”) that is, or is identical to, the particular property, and

(b) at the end of that period, the taxpayer or a person affiliated with the taxpayer owns or had a right to acquire the substituted property.

This section, covering a thirty day period either side of the transaction involving the capital loss, is similar to the US legislation. However, as mentioned above, it is more relevant in Australia’s case as Canada also has anti-avoidance legislation whereas the US does not.

These legislative sections in both Canada and the US provide a clear rule for taxpayers to follow, especially regarding the sale and repurchase of shares in the same company. The effectiveness of legislation that is specific such as this is often brought into question. Although some writers in these countries have suggested “several strategies for dealing with the wash sale rules”,⁴⁶ these strategies do not actually involve buying within the 30 day period either side of the sale. All the “strategies” still involve having to wait the 30 days. In their article “Evaluating the Effectiveness of Code Section 1091 as a Deterrent to Wash Sales”,⁴⁷ Everett and Norton conduct an analysis of ex-post stock price data for 100 firms over a five-year period to determine if sale-repurchase security transactions which fall outside the 30-day wash sale rule could still be potentially profitable. They found that the transactions do tend to produce positive short-term savings. However, they acknowledge that their findings ignore the psychological effects on an investor of such a waiting period. The investor would have to be risk neutral. They even suggest the waiting period could be extended to 60 or 90 days to increase the “risk” faced by investors who attempt this type of transaction. Although this study is now quite dated one would assume that a similar result would be achieved in today’s market.

In a more recent article, Schizer⁴⁸ believes “the wash sale regime of Section 1091 is one of our system’s most important brakes on the timing option.” However, like Everett and Norton, he feels the section does not go quite far enough. The wash sale rules in the US are quite old⁴⁹ and aggressive tax planning using newer types of securities may escape being covered by the rules. The current rules usually do apply when shares are replaced with options. However, some other types of “securities” such as derivatives may not be covered by the current regime. Although this refers to the US legislation it is just as relevant for the Canadian situation as the rules are virtually the same.

⁴⁵ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 40(2)(g)(i) and Section 54.

⁴⁶ Leonard J. Lauricella, Year-End Tax Planning: Wash Sales Aren’t Always Bad (2005) <http://taxprof.typepad.com/taxprof_blog/files/2005-25306.pdf> at 28 September 2007.

⁴⁷ John O Everett and Curtis L Norton, ‘Evaluating the Effectiveness of Code Section 1091 as a Deterrent to Wash Sales’ (1981) 16 *The Financial Review*, 3, 4-56.

⁴⁸ David M Schizer, ‘Scrubbing the Wash Sale Rules’ (Working Paper No 242, The Center for Law and Economic Studies, Columbia Law School, 2004) 2.

⁴⁹ Section 1091 was originally enacted in 1921.

The goal of wash sale rules is to discourage tax-motivated sales of securities. This could be achieved in Australia by enacting specific legislation with a specified period during which the wash sale rules would apply. This regime would then burden loss “harvesting” with a non-tax cost: taxpayers have to give up economic exposure to the particular security for a specified period of time. The hope is that this extra “cost” would be so unappealing that taxpayers would choose instead to forgo the loss or at least truly realise a loss and end their economic exposure to the asset.⁵⁰

The introduction of a specific wash sale rule would also help alleviate the vagueness created by the new Ruling and Part IVA. There are many advantages of having specific legislation. A specific rule provides certainty and guidance to taxpayers and advisors. They are able to plan their investment activities with absolute knowledge of the way their actions will be interpreted. A specific rule may also be easier for the ATO to administer as it would be a self-operating provision and administrators could search for transactions that breached the time period set by the specific rule. Part IVA is not a self-operating provision and requires the Commissioner to exercise his discretion on whether to apply Part IVA to a particular transaction.

It is important to recognise that there are disadvantages to such specific rules. One disadvantage of a specific legislative regime is that it would add complexity to the already complicated taxation legislation. However sometimes the addition of a rule which gives specific “black and white” guidance as opposed to general provisions such as Part IVA are advantageous to taxpayers and advisors.

It is commonly believed that the more specific and detailed a system’s rules become, the more ways people will find to circumvent the rules.⁵¹ It is acknowledged that specific legislation would not stop the attempts of some taxpayers to use wash sales. There would still be taxpayers willing to risk the time period and sell shares with the intention of buying them back at the end of the time and those who find some other way around the specific rule. However, even without specific legislation there will always be taxpayers who attempt to “work the system”. One could make sure they sell their shares around the time of the release of annual profit figures. The repurchase of the shares could then be said to have a dominant purpose other than a tax benefit (even if that is not true). It is worth remembering that Part IVA would still exist as an overriding provision and could still be applied to taxpayers who try to circumvent the specific legislation should the Commissioner feel their dominant purpose was that of tax avoidance.

Another disadvantage is that by allocating a specific time in which a sale/repurchase could not take place there is also the possibility that the legislation would block behaviour that is not tax-motivated. A taxpayer may sell a security that they truly no longer want, but then due to a change in circumstances (eg the release of profit figures that show a marked turnaround in performance), may wish to regain ownership of the asset. A specified waiting period would mean the taxpayer could not regain the asset immediately and may have to pay a far greater price when the waiting period expired.

⁵⁰ Schizer, see above n 48.

⁵¹ Prebble and Prebble see above n 24.

VI CONCLUSION

A good tax system should be simple to understand and easy to apply to individual circumstances. The release of the Ruling on the application of Part IVA to wash sale arrangements is vague and broad in terms of the transactions it is attempting to cover. It is not specific with regards to time periods or types of assets involved. Considering the large number of “average” taxpayers such a ruling may affect, this vagueness will lead to uncertainty and concern for many of these taxpayers and their advisors.

The introduction of specific legislation concerning wash sales (similar to that in Canada and the US) would bring more clarity and certainty for the many investors and advisors struggling with the implications of Part IVA and the Ruling. Even though there are those who argue that more legislation makes the tax system more complicated there are some situations where a specific rule adds to the simplicity of the system as far as taxpayers and advisors are concerned. A specific wash sales regime in the legislation, if crafted with care, could add simplicity for taxpayers and advisors compared to the vagueness of the draft ruling, whilst enhancing the efficiency of the realisation-based capital gains regime. The specific regime would still have the overarching principles of the General Anti-Avoidance Rules to deter those who try to circumvent the specific rules. Such a regime needs to be tough enough to reach a point where enough taxpayers are deterred from harvesting losses and clear enough that taxpayers feel confident in following the “rules”.