

To sell now or sell later?

What are the capital gains tax implications on share sales held for less than one year and after one year? **KIM WYATT**, **NIHAL MUDALIGE** and **JARROD McDONALD** explain.



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Investors in the stock market are faced with many uncertainties. Changing economic climates, fluctuating business confidence, uncertain business profits, and varying interest rates can all affect investors' confidence and the performance of the stock market. Throughout this haze of uncertainty, there is one common factor that unites all investors: No matter how their investments perform, they want to minimise the amount of tax they will have to pay when their investment is crystallised.

The Australian All Ordinaries index broke through the 4,000 barrier and appreciated by almost 21% in 2004 (Charles, 2004). The strong performance of Australian equities may prompt investors to consider their share holdings and possibly realise some gains. Investors focused on overall returns should, however, consider the tax implications of selling investments at a given time before making the final commitment to sell.

The Australian Tax Office (ATO) media release on 17 August 2004 details its targeted areas for compliance in the 2004–05 financial year. For individual taxpayers an area of increased focus will be on capital gains tax. In the 2002–03 financial year, there was a net capital gain of \$6.2 billion dollars from share and property sales declared by 765,000 individuals. This net capital gain increased by 5% although the number of individual taxpayers declaring capital gains fell by 27% (ATO, 2004).

Capital gains tax compliance by individuals makes the holding period of an investment a critical decision. The difficulty lies in determining the optimal

time to sell an investment. Under current tax laws, the length of time that an investment is held (i.e. the holding period) will influence the tax-effectiveness of the return. For individuals, where a security is sold within a holding period of one year, at a price greater than the original purchase price, then the capital gain for that transaction is treated as income for the current period, and taxed at the investor's marginal tax rate. Conversely, if a security is sold after a holding period of more than one year, then only 50% of any resulting capital gain is treated as income and taxed at the investor's marginal tax rate. This in effect means that the capital gain is taxed at half the marginal tax rate of the investor, which results in a substantial tax saving.

Therefore it appears to be advantageous to hold onto securities for more than one year. However, the stock market can be volatile and uncertain. If an investor expects the price of the stock to fall, then they may be tempted to sell before the holding period of one year passes in order to ensure a capital gain. If, however, they do sell within the year, the full amount of that capital gain will be taxed at the investor's marginal tax rate.

INVESTMENT QUANDARY

This therefore leaves the investor with an investment quandary: Should you sell your shares within the year or after one year? The decision to be made is whether to sell within a year after purchase and pay tax on 100% of the capital gain at the investor's marginal tax rate, or to hold the shares for more than a year and thus only pay tax on 50% of the capital gain, at the investor's marginal tax rate.

Due to the favourable treatment of capital gains on shares held for more than one year, it is possible to sell the shares after one year at a lower future price and receive the same overall after-tax cash proceeds as selling at a higher current price within the one-year holding period.

The question for the investor who sees the price of the security increase during the first year of purchase is: What is the minimum future price a share held for more than a year could drop to that would enable me to be no worse off than if I sold now and paid the higher capital gains tax?

A formula has been developed that answers this question, which will assist accountants, stockbrokers and financial advisers when dealing with this query from their clients.

The formula allows for brokerage as well as taking into account an investor's differing marginal tax rate. The formula determines the minimum share price after one year in order for the investor to obtain the same after-tax proceeds from the sale that would have been possible if the investor sold the shares within one year at the current higher market price.

The formula is:

Break even price on market (BEP) before brokerage =

$$\frac{(1 - \text{MTR})[(1 - B)\text{SP}] - (1 + B)\text{PP}}{(1 - 1/2\text{MTR})} + (1 + B)\text{PP}$$

where: MTR = Investor's marginal tax rate

B = Brokerage percentage on sale and purchase of shares

SP = Current selling price of shares

PP = Purchase price of shares

Where a fixed brokerage fee is charged then this will need to be converted to a percentage in order to use this model.

The above formula does not take into consideration the opportunity costs associated with the decision to sell a share at a later date rather than selling it at an earlier date. Cash received at an earlier date is always better than an equivalent amount of cash received at a later date due to two reasons:

1. The uncertainty or risk of not receiving the cash (at a future date);
2. The possibility of investing the cash received today for extra income. (This income is forgone if cash is received at a later date and is the opportunity cost of the decision to sell the shares and receive the cash at a later date.)

The formula also assumes that no dividend (as well as bonus issues, options or rights issues) will be paid from today (day of decision making) up to the intended date of sale if the shares were to be kept for at least one year.

The formula should therefore only be used in the short term to provide investors with some additional information about the tax effects on a decision to sell before one year or immediately after one year. An example of this would be where an investor has held shares for eight months and no dividend is expected in the next four months.

Then this model will assist the investor in deciding whether to sell now (today) or wait until the shares have been held for one year and then sell.

Example

Assume an investor bought shares originally for \$10 and has seen the price rise to \$15 in the first nine months. A dividend has been paid last month and another is not expected for a further six months. Brokerage is 1% and the investor's marginal tax rate (MTR) is 48.5%. If it is decided to hold onto the shares for at least one year, what is the minimum price the shares could drop to in order for the investor to obtain the same after-tax proceeds that would be obtained by selling the shares now at the current selling price of \$15?

$$\text{SP} = \$15 \quad \text{PP} = \$10 \quad \text{Brokerage} = 1\% \quad \text{MTR} = 48.5\%$$

$$\text{BEP} = \frac{(0.515)[(1.99\{15\}) - (1.01\{10\})] + (1.01)10}{0.99}$$

$$\frac{3.2294 + 10.10}{0.99} = \$13.46$$

Sell now within one year at \$15.00:

Proceeds after brokerage	= \$14.85 (\$15.00 - 0.15)
Purchase after brokerage	= \$10.10 (\$10.00 + 0.10)
Profit	= \$4.75
Tax = (48.5% x \$4.75)	= \$2.30375

$$\text{After-tax proceeds} = \$14.85 - \$2.30375 = \$12.54 \text{ per share}$$

Sell after one year at \$13.46:

Proceeds after brokerage	= \$13.3254 (\$13.46 - 0.1346)
Purchase after brokerage	= \$10.10 (\$10.00 + 0.10)
Profit	= \$3.2254
Tax = (0.5 x 48.5% x \$3.2254)	= \$0.7822

$$\text{After-tax proceeds} = \$13.3254 - \$0.7822 = \$12.54 \text{ per share}$$

The implications for this particular investor are as follows:

1. As illustrated by the above calculations, the after-tax gain is the same whether the shares are sold at \$13.46 after the one-year holding period, or at the current price of \$15.00 before the one-year holding period is up.
2. If the investor expects the price of the shares to fall below \$13.46 after a one year holding period, it is better to sell the shares at the current price.
3. If the investor expects the price of the shares to be above \$13.46 after a holding period of one year, it is better to hold the shares and sell after the one-year period is up.

The formula was set up in a spreadsheet by the authors so that a number of "what if" situations could be reviewed. Using the above example, break-even prices at varying marginal tax rates can easily be derived (See Table 1).

Table 1 shows that for individuals on low marginal tax rates, the BEP is higher than for those individuals on higher

marginal tax rates. Hence, low marginal tax rate investors need to be aware that there is a smaller gap between the current selling price and the BEP.

The importance of being aware of the relevant BEP can be demonstrated thus: In the above example, investors may feel that the stock is overvalued by \$1 and will return to \$14 before the end of the year. In this case, investors on marginal tax rates of 31.5% and less would be advised to sell their shares now at the current price of \$15, whilst investors on the 43.5% and 48.5% MTR would be advised to hold onto their shares for at least one year, and thus benefit from the tax break.

A PRACTICAL CASE

Macquarie Bank Limited (MBL) shares over the past year (as at 6 January 2005) have traded as low as \$31.61 and as high as \$47.15. On Thursday 6 January, MBL's share price was \$46.94 and no further dividends were expected until mid May 2005.

Assuming that an investor bought MBL shares at \$32.00 during the year and the date of their one-year holding period will fall before May (say 30 April), then Table 2 shows the BEP as at 6 January for this investor at varying MTRs when the current selling price was \$46.94. That is, on 6 January, this investor would need to decide whether they felt that the MBL share price would fall below these BEP levels by 30 April at the various MTRs. If this investor was at the 48.5% MTR, then a decision would need to be made as to whether the share

TABLE 1: BREAK-EVEN ANALYSIS AT VARYING MARGINAL TAX RATES

SP	\$15.00	\$15.00	\$15.00	\$15.00	\$15.00
PP	\$10.00	\$10.00	\$10.00	\$10.00	\$10.00
Brokerage	1%	1%	1%	1%	1%
MTR	0.00%	18.50%	31.50%	43.50%	48.50%
BEP	\$15.00	\$14.51	\$14.10	\$13.67	\$13.46

TABLE 2: BREAK-EVEN ANALYSIS OF MBL SHARES AT VARYING MARGINAL TAX RATES

SP	\$46.94	\$46.94	\$46.94	\$46.94	\$46.94
PP	\$32.00	\$32.00	\$32.00	\$32.00	\$32.00
Brokerage	1%	1%	1%	1%	1%
MTR	0.00%	18.50%	31.50%	43.50%	48.50%
BEP	\$46.94	\$45.48	\$44.27	\$42.97	\$42.36

price would fall below \$42.36 by 30 April. If it was felt that the MBL share price would remain around the current share price and not dip below \$42.36, then the investor's decision would be to hold the shares until 30 April.

If on the anniversary of holding these shares on 30 April, we find that MBL's share price was \$44.00, then Table 2 demonstrates the best time to sell, based on an investor's MTR. For example, if an investor's MTR was 43.5% or 48.5%, then this investor would have been better off holding their shares for the one-year period and then selling on 1 May, rather than selling earlier on 6 January at \$46.94. Conversely the investor with a MTR of 31.5% or less would have been better off selling on 6 January and paying capital gains tax on the whole gain, rather than holding the shares for more than one year in an attempt to benefit from the reduced capital gains tax.

Where investors feel that the current share price is too high and may decline in the near future then a decision on when to sell needs to be made. This model has been developed to assist investors considering selling their shares in the short term. The decision for investors on low marginal tax rates is more crucial than for those investors on high marginal tax rates as the difference between the current selling price of the shares and the projected BEP is less.

References

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