Fifty shades of Greig: the spectrum of taxpayers in share trading

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***Greig v FCT* is the latest in a long line of cases considering the taxation of share trading by reference to a wide survey and exact scrutiny of the facts and circumstances relevant to each decision. The authors consider the consequential development of the law by reference to the characteristics of the spectrum of some of the participants in share trading, which they have termed "gamblers", "long-term investors", "speculators" and "share traders".**

Introduction

The proper characterisation of gains and losses arising from trading in publicly listed shares invokes the fundamental distinction inherent in the income tax law between those gains and losses falling onto revenue account and those falling onto capital account. Unsurprisingly, courts have approached the distinction on "a wide survey and an exact scrutiny"[1] of each taxpayer's activities as established by the evidence on a case-by-case basis in the development of settled principles.

The approach is illustrated by the most recent appellate decision concerning the taxation of share trading, *Greig v FCT*.[2] The court there stressed that it was a "well-established" proposition that "a gain will constitute income if the property generating that gain was acquired in a 'business operation or commercial transaction' for the purpose of profit-making by the means giving rise to the profit", notwithstanding that "[p]revious authorities … tended to focus on the existence of the required profit-making purpose rather than upon the need for there to be a 'business operation or commercial transaction'".[3]

This article proposes an alternative consideration of the application of the tax law by reference to the characteristics of a spectrum of participants in share trading, with the attributes resulting in the tax consequences of their activities being seen as a consequence of their characterisation on that spectrum rather than the individual facts and circumstances of each case. With increasing trading activity in the share markets due to growth in the accessibility and sophistication of financial instruments and trading platforms, it is unsurprising that this spectrum and the unique characteristics and circumstances are wide and varied, ranging from natural persons making singular transactions in the nature of a bet to complex transactions by institutional investors.[4] This article focuses on four types of taxpayers from that spectrum who may be termed "gamblers", "long-term investors", "speculators" and "share traders".

The "gambler"

A gambling or wagering contract, strictly speaking, would result in no tax consequences, as: (1) any gain would arise solely as a windfall;[5] (2) no loss would have the requisite purpose to give rise to an allowable deduction;[6] and (3) the capital gains tax (CGT) consequences would be disregarded.[7]

The nature of a gambling contract at common law is governed by the celebrated case of *Carlill v Carbolic Smoke Ball Co*,[8] where the essential characteristic of a wager was defined to be that each party might win or lose depending on the issue of an event, and the outcome of which thereby remained uncertain until that issue was known. That definition excludes any true acquisition and sale of shares from comprising a gambling contract. Accordingly, although a taxpayer may acquire shares for the mere chance of a gain and, in that economic sense, the circumstances would be no different to a bet placed with a bookmaker on the value of the share at a future time, the mere form of the transaction would engage different principles.

Nevertheless, in many ways the same economic substance of share trading may be achieved without any underlying acquisition of shares. For example, in addition to a true bet on an outcome, in TR 2005/15, the Commissioner accepted the possibility that gains and losses from the execution of financial instruments may be the product of gambling. The ruling considers the circumstances where a gain or loss from a financial contract for differences may be the product of gambling. Drawing on horse race betting cases, the ruling observed that: (1) gains that are dependent on a significant element of skill in contradistinction to chance are more likely to have tax consequences than gambling on merely random events; and (2) the more closely an activity is identified as being undertaken for private or recreational purposes, in contradistinction to commercial purposes, the less likely it is that it will have tax consequences.[9]

In *Case* X85,[10] the Commissioner contended before the Administrative Appeals Tribunal that a loss suffered by a research scientist in an "isolated adventure" of trading share price index futures was the product of gambling and therefore not deductible. The tribunal rejected the contention on the basis that the activity in issue was essentially commercial, in the sense that it comprised buying and selling assets as part of a productive process.[11] But the reasoning of the tribunal suggests that a different decision may have resulted if the transaction involved a contract for differences or some other type of arrangement outside of the ordinary "productive financial system".[12] To the same end, in TR 2005/15, the Commissioner considered but rejected an "alternative view" that tax consequences of cash-settled

financial derivatives more broadly may be disregarded unless a business is carried on.[13]

The more difficult question for a gambler on the share markets is why a true bet (placed, for example, with a bookmaker by reference to a particular price (or range of prices) of identified publicly listed shares at a specified future time) should be treated any differently to an acquisition of shares merely because of the form of the transaction. The authors suggest that it should not, and that the true criterion for characterising a taxpayer as a "gambler" turns on whether the taxpayer's conduct may be identified as an inherently rational means of deriving profits (at the risk of losses), or whether the nature of the conduct was truly derived from the psychological thrill of pursuing wins in an irrational context. That would result in a distinction for tax purposes between two main categories of shareholders. First, taxpayers betting (or equivalent) in circumstances where the odds payable on successful bets were controlled by the bookmaker (or equivalent), thereby suggesting that, with sufficient bets over a course of time, the odds would dictate that the gambler ultimately loses. Second, sophisticated taxpayers (say, a merchant bank) making bets on the stock market where the sophistication and size of the taxpayers enabled them to obtain control of the specific outcome in some way — whether by an underlying economic manipulation of the odds, by preferential industry advantage placing the taxpayers on a more level playing field with the bookmaker, by the odds being taken into account as part of the taxpayers' wider activities (eg hedging foreign investment gains and losses), or otherwise — thereby rendering the betting as inherently rational conduct. Being carried out in a systematic business-like manner,[14] those factors would tend to substantiate that a gain or loss was not of a private or recreational nature, but instead has the character of a business or commercial deal.[15]

The "long-term investor"

The long-term investor describes a taxpayer who has acquired publicly listed shares with the expressed purpose of holding them for dividend returns over the long term, and with the prospect of expanding capital wealth by the increasing value of a share portfolio over time. Given the steady increase in the value of the share markets over the past decades, the associated tax benefits arising for such taxpayers encourage this classification. That remains so notwithstanding complexities which may arise in some situations, such as in the case of the acquisition of shares listed on overseas stock markets, which may require a taxpayer to consider several matters, such as the application of double tax treaties and entitlement to foreign tax offsets. Those complexities were recently illustrated by *Burton v FCT*,[16] where the Federal Court held that, consistently with art 22(2) of the Australia–US tax convention, Div 770 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) only applied to that portion of a capital gain included in the taxpayer's assessable income after the 50% CGT discount was applied to the gain.[17]

Nevertheless, in general terms, interest on borrowings would have the requisite income-producing purpose (ie the derivation of dividends) for it to be an allowable deduction, thereby enabling the scope for negative gearing, although it should be borne in mind that an enquiry into the purpose of borrowings is always permissible wherever allowable deductions for the borrowings exceed assessable income from the dividends.[18]

In addition, the 50% CGT discount would also be available for relevant taxpaying entities who hold shares.[19] As such, the classic distinction between taxable revenue gains and formerly tax-free capital gains remains of significant ongoing relevance to taxpayers. The distinction is particularly relevant when it comes to circumstances where shares are sold either to maintain or rebalance a portfolio, and whether the way in which this is carried out (eg on a regular basis) causes the gain to be on revenue rather than capital account. That is especially so because the minimum 12-month period prior to the availability of the CGT discount[20] is commonly misapplied as a sufficient, rather than necessary, entitlement to characterise shares as held on capital account. To put it another way, the considerations in relation to the classic distinction are relevant, and need to be considered, regardless of whether shares have been held for 12 months or more. For example, the decision in *London Australia Investment Co Ltd v FCT*[21] continues to be relevant. In that case, although a taxpayer's business was investing in shares with a primary purpose of obtaining income by way of dividends, the conduct of the business required that the portfolio should be given regular consideration and that shares should be sold when the dividend yield dropped below specified levels which, for practical purposes, was when the shares increased in value. The High Court held that a sale of the shares was a normal operation in the course of carrying on the business of investing for profit. It was not a mere realisation or change of investment. If the CGT discount had applied to the taxpayer in this case, any share that was held for 12 months or more would not have affected the characterisation of the profit as assessable on revenue account. As Steward J noted in *Greig's* case:[22]

> "In *Whitfords Beach*,[23] the profit-making plan commenced in late 1967 and assessable profits were made from 1971 over a period of years. It is not antithetical to a profit-making undertaking for a taxpayer to wait for the profit to become realisable, so long as that was the profit the taxpayer planned to secure. Waiting, without more, will not convert the profit eventually realised into an affair of capital."

The "speculator"

The "long-term investor" has been characterised in contradistinction to the "speculator", being a taxpayer who exercises skill and judgment in acquiring shares by way of a commercial transaction, with a profit-making purpose or intention. A key issue for the speculator is whether gains and losses should be brought to account under a "gross receipts method" (often referred to as the "basic approach") or by "net profit accounting". Under the former method, an allowable deduction is claimed when a share is acquired and income is recognised when it is sold. Under the latter, only the net profit or loss arising at the end of the transaction is recognised. Generally, the gross receipts method applies if a taxpayer carries on a business, and net profit accounting applies if the taxpayer engages in something less than that, namely, a profit-making undertaking, and the CGT rules do not apply.[24]

On a more cynical view, taxpayers making gains seek to be characterised as long-term investors in order to obtain

the tax reductions from that characterisation (as in *London Australia Investments*), whereas those with losses seek to be characterised as speculators to obtain the allowable deduction. An example of the latter is *Case* X85, discussed above. The tribunal there, in allowing the claimed losses, stressed the commercial nature of the activities under the *Myer Emporium* principle.[25]

Greig's case is another example. In that case, the taxpayer purchased shares in an ASX-listed company on 64 occasions over a 25-month period, at a total cost of $11.85m. He also expended $507,198 on legal costs in court proceedings whereby he contested a deed of company arrangement which otherwise compelled him to transfer the shares to a third party for nil consideration. Having lost that case, he incurred a loss of $11.85m on the disposal of his shares. His litigation with the Commissioner concerned the deductibility of that loss and of his legal expenses. It is of note that the parties conducted the case on the common footing that that deductibility was governed by the application of the *Myer Emporium* principle to the share acquisitions, notwithstanding that the principle concerned the assessment of gains.

The Full Federal Court[26] found, on that footing, that the shares were acquired with a view that they be sold at a profit in the short term in a "business operation or commercial transaction" because: (1) the profit would have been the result of the implementation of an intention or a purpose existing at the time of the acquisition of each share of profit-making from their sale; (2) the realisation of profit formed part of the taxpayer's overall sophisticated plan to generate cash profits prior to his retirement within four to five years; (3) the shares were acquired in a systematic fashion on 64 occasions; (4) of the taxpayer's participation, either personally or through the agency of his adviser, in a plan to crystallise indirectly what the taxpayer perceived was the true value of the underlying asset owned by the company in which the shares were acquired; (5) the taxpayer used his business knowledge and experience, which was applied on each occasion he decided to buy shares; and (6) the taxpayer relevantly acted as a "business person".[27]

On one hand, these expressions of the test reflect that the threshold for gains and losses to be on revenue account is not high, yet still requires a certain degree of sophistication. On the other hand, it is difficult to see that the majority was not influenced by the scale of the taxpayer's conduct, and in his persistence in pursuing the shares for his view of their potential value through complex and expensive litigation challenging the deed of company arrangement. So much was apparent by the comment of Steward J that, notwithstanding the taxpayer's statements to the contrary, the shares in issue were not acquired "in a meaningfully different way" from 218 other share purchases of the taxpayer who held upwards of 44 different stocks during the period in issue. As Steward J found, he "made gains as well as losses".[28]

The "share trader"

A share trader's dealings take the character of a continuing business enterprise. The tax treatment of a share trader is more complex, as a share trader is also likely to be engaged in other sophisticated trading activities involving more complex financial instruments (eg options and other derivative instruments). The trading stock provisions would normally apply. More sophisticated traders may seek to apply the specialised provisions for the taxation of financial arrangements under Div 230 ITAA97. On the other hand, trading losses of high-wealth natural person share traders, with taxable incomes above the $250,000 threshold for the application of Div 35 ITAA97,[29] may not be deductible against non-share trading income due to the operation of that Division.

The question of whether a taxpayer is carrying on a business of share trading involves the general indicia of conducting a business, among many others, including: (1) repetition and regularity in the buying and selling of shares; (2) whether the taxpayer is operating to a plan, setting budgets and targets, and keeping records; (3) maintaining an office; (4) accounting for the share transactions on a gross receipts basis; and (5) whether the taxpayer is engaged in another full-time profession.[30]

The threshold to establish whether a taxpayer is carrying on a share trading business tends to be high. The cases are littered with taxpayers who have unsuccessfully contended that they were share traders seeking to claim allowable deductions for their losses. Examples include a retired engineer trading the market with his superannuation and a $600,000 investment loan,[31] a council employee trading shares worth between $385,938 and $934,575 in an income year,[32] and a dentist who claimed that he studied the share market in a business-like manner.[33]

On the other hand, in *Case* X31,[34] a taxpayer established that she was carrying on a business of dealing in silver, albeit in a small way. In that case, she acquired several kilograms of silver in three separate transactions between January 1980 and September 1981. Her success was founded on the regularity and repetitiveness of her transactions, and a finding that each purchase was a commercial decision, carefully made after regular analysis of the market by the taxpayer. Moreover, as Steward J noted in *Greig's* case,[35] the cases indicate that it is unnecessary for taxpayers to personally conduct the activities, resulting in the finding that a business was being conducted; it was sufficient for the activities to be conducted by an agent.[36] Hence, Steward J stated that:[37]

> "… the fact that the taxpayer engaged a stockbroker to undertake his share trading, is of no moment. It may be accepted that the taxpayer was enormously busy and relied in large part on the services of [an agent] to undertake research, to meet company representatives and to undertake the trades. It is also accepted that much of the taxpayer's own physical activity was limited to meetings with [the agent], monitoring his investments and undertaking some research."

Concluding remarks

The title of this article was intended (wordplay aside) to highlight the spectrum of participants in the share market, and to prompt thinking about how an issue that has vexed many for more than a century[38] might be approached in a different way. It goes without saying that care must always be taken not to supplant statutory requirements by simply referring to settled principles and judicial guidance from other cases. Furthermore, even settled principles require considered application to the particular facts in each case. However, for specific activities, such as the share trading considered here, the authors suggest that descriptive characterisations arising from a reverse-engineered consideration of the judicial process may assist in a

perspicacious understanding of the apposite issues, and how they may be approached, in a more enlightened way.

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References

1 *FCT v Stone* [2005] HCA 21 at [19], citing *FCT v Montgomery* [1999] HCA 34 and *Western Gold Mines NL v FCT (WA)* [1938] HCA 5.
2 [2020] FCAFC 25.
3 *Greig* [2020] FCAFC 25 at [227] per Steward J (with whom Kenny J agreed, Derrington J dissenting), referring to *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 at 209-210.
4 Institutional investors, such as banks, insurers and hedge funds, are generally subject to specialised rules (see, for example, Div 230 ITAA97) and are beyond the scope of this article.
5 RW Parsons, *Income taxation in Australia: principles of income, deductibility and tax accounting*, Lawbook Co, 1985, paras 1.71 and 2.158. See also *Greig* [2020] FCAFC 25 at [245].
6 S 8-1 ITAA97.
7 S 118-37(1)(c) ITAA97.
8 [1892] 2 QB 484 (affirmed on appeal, [1893] 1 QB 256).
9 Para 43 of TR 2005/15.
10 *Case* X85, 90 ATC 615.
11 *Case* X85, 90 ATC 615 at [22].
12 This is a term coined by the authors, having regard to the reasons in *Case* X85. The emphasis on "productive" relates to whether the traded instruments form part of the day-to-day commercial transactions, such as futures contracts, which are used as hedging instruments.
13 Paras 46-73 of TR 2005/15.
14 For example, see *Brajkovich v FCT* [1989] FCA 454.
15 *McLelland v FCT* (1970) 120 CLR 487 at 494-495. See also TR 2005/15 which recognises that there may be rare situations where these factors are present and determinative.
16 *Burton v FCT* [2019] FCAFC 141.
17 It should be noted that, given the ever-expanding range of available financial investments as alternatives to shares, for example, options or instalment warrants, long-term investors must also concern themselves with the particular rules that are applicable to those instruments.
18 *Fletcher v FCT* [1991] HCA 42 (cf TD 2004/1 which considers the deductibility of outgoings where the purpose of an investment is solely long-term capital growth).
19 S 115-10 ITAA97.
20 S 115-25 ITAA97.
21 *London Australia Investment Co Ltd v FCT* [1977] HCA 50.
22 *Greig* [2020] FCAFC 25 at [246].
23 *FCT v Whitfords Beach Pty Ltd* [1982] HCA 8.
24 *FCT v Montgomery* [1999] HCA 34 at [111]-[112]. See also paras 67-69 of TR 96/4.
25 *Case* X85, 90 ATC 615 at [22]. For a more in-depth discussion of the *Myer Emporium* principle, see D Boccabella, "Myer isolated transactions doctrine (first strand) at 33-year anniversary", (2020) 24(1) *The Tax Specialist* 15.
26 Kenny and Steward JJ, Derrington J dissenting.
27 *Greig* [2020] FCAFC 25 at [245].
28 *Greig* [2020] FCAFC 25 at [250]-[252].
29 This is due to the operation of s 35-10(2E) ITAA97.
30 *Hill and FCT* [2019] AATA 1723 at [17].
31 *Hill and FCT* [2019] AATA 1723.
32 *Hartley and FCT* [2013] AATA 601.
33 *Case* 6297 (1990) 21 ATR 3747.
34 *Case* 5770 (1990) 21 ATR 3291; *Case* X31, 90 ATC 296.
35 *Greig* [2020] FCAFC 25 at [247].
36 See, for example, *Ferguson v FCT* [1979] FCA 29, *FCT v Lau* [1984] FCA 401 and *Puzey v FCT* [2003] FCAFC 197.
37 *Greig* [2020] FCAFC 25 at [247].
38 See, for example, *Californian Copper Syndicate v Harris* (1904) 5 TC 159.