Australian Shareholders' Association

Standing up for shareholders

The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Monday, 27 August 2007

Dear Sir

REVIEW OF THE TAXATION TREATMENT OF OFF-MARKET SHARE BUYBACKS

Thank you for the opportunity to comment on the above discussion paper. Our comments follow and are restricted the off-market buybacks mounted by listed companies.

Please contact us if you wish to discuss this topic further.

Yours Sincerely

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REVIEW OF THE TAXATION TREATMENT OF OFF-MARKET SHARE BUYBACKS

ASA experience

Over recent years, we have received many positive comments about off-market share buy-backs as many of our members run their own superannuation funds which attract the preferential 15% tax rate for all their transactions, not just these buy-backs. To a great degree it is the lower tax rate, which has been introduced to encourage us all to provide for our retirement that drives attractiveness of participating in such transactions.

Historical calculations have shown that participating shareholders with lower tax rates (under 18%) generally benefit from share buybacks. Shareholders with these characteristics include ASA members such as retirees, self-managed superannuation funds and institutional funds (who are ultimately owned by mums and dads).

We receive some negative comments that the process is not fair as taxpaying shareholders on higher rates of marginal taxation perceive inequity in some shareholders making a greater after-tax return and receiving additional franking credits that are not (profitably) available to all shareholders.

Other negative comments, received from aspiring participants, apply to the uncertainty of the final taxation outcome with both the tender process and the deemed capital price becoming known through the tender process. This uncertainty makes some retail investors uncomfortable, though others are quite comfortable with the guidance provided.

We have also received enquiries from shareholders who find the documentation too complex to understand on their own, who wonder whether it is worth paying a fee for their advisor or accountant to assess the transaction, and do not easily find information on the benefits of the transaction for non-participating shareholders. We would like to see companies include, at the front of the document, a statement of the estimated increase in value of their shares (due reduced number of shares on issue and the cheaper buy-back price) for those shareholders who otherwise ignore this transaction and explanatory documentation.

As all shareholders have different portfolio structures, liquidity requirements, attitude to risk, income tax rates, capital gains tax situations and sometimes assets tests implications, it is impossible to generalise as to what the best strategy for ASA members. Analysis of earlier share buybacks have shown a do nothing strategy can benefit some from the saving to the company (when buy-back price is compared with market price) and the reduced number of shares on issues, even after the value of franking credits lost is taken into account.

ASA Position

The ASA Policy Statement, *Shareholders expect*, covers capital management in section 3. The subsections relevant to this discussion appear below:

"***3. Issuing and management of equity capital***
3.1 Capital management
Management of debt and equity capital levels through such methods as debt raising, issues of equity, and reductions of capital (including share buybacks), is the responsibility of directors. Shareholders expect directors to exercise this function in a way that is consistent with the continued solvency and value of the company and that is equitable to all groups of shareholders, and that achieves optimal shareholder value at an acceptable level of risk.

3.3 Compulsory acquisition of small holdings

ASA supports the concept of rationalisation of share registry costs by acquisition and cancellation by the company, at no cost to the shareholder, of security holdings that are less than a marketable parcel (presently defined as a holding with a market value of at least $500). However, shareholders expect to be given reasonable notice – normally a minimum of six weeks - of the intention of the company to acquire their holding (or refusal to register a newly acquired holding), and the amount paid to be at least as great as the market price on the date of the notification."

In order to satisfy the requirement for equity we would not expect the tendered share buybacks to replace ordinary dividends or curtail the growth of ordinary dividends. Further we would expect the board to have assessed whether a special dividend would be a more appropriate method of distributing the franking credits.

We acknowledge there will be circumstances where the tendered share buyback is the most appropriate capital management action for the company to undertake (where the cheaper buyback price compensates non-participating shareholders for franking credits forgone). The off-market buyback tender represents a way to maximize the return to participating and non-participating shareholders. This is also an opportunity to sell without paying brokerage.
With a proportional share buyback offer, there will be some shareholders who wanted to increase or maintain their holding (by value), while others who wanted to sell a greater quantity of shares will continue to sell on market. With a tender only the willing sellers will sell – they may even be willing to pass on part of the brokerage saving. Taking sellers out of the market can benefit the share price temporarily as the ratio of sellers to buyers drops, and there will also be a permanent enhancement of earnings, cash flow and net asset backing per share, due to the lower number of shares on issue.

In relation to the tax forgone we note that franking has addressed the issue of double taxation on distributed earnings, leaving an asset being the balance of the franking credits. This is an asset that rightfully belongs to the shareholders.

In relation to the capital gains tax forgone, other parties will be more able to address the fairness in terms of the appropriate levels of taxation for various taxpayers to pay. We speak to many shareholders who are very long term shareholders and would generally minimise the crystallisation of a capital gain without an offsetting capital loss. We would expect that any assessment of the lost CGT revenue to the ATO would include an assumption that a number of these shares would not have been traded at this time.

EQUITY

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SHARE BUYBACK TENDERS

What should you take into account when you receive the documentation and forms for a tendered share buyback? Why is the price range lower than the market price?

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Initially, as with any unsolicited offer, it is helpful to put the offer out of your mind and ask yourself whether you were planning to increase or decrease your investment in shares? Where does the company fit in your portfolio – were you planning to increase or decrease your holding in this particular company? This sets the context for looking at the offer.

With an off market share buyback, the company decides it has excess funds which it can distribute as a dividend or return of capital or combination of both. Historically this was often achieved by a pro-rata return of capital or buyback. The off-market buyback tender (the table at the foot of page two provides a sample) represents a way to maximise the return to participating and non-participating shareholders in a fair and accessible manner. This is your opportunity to sell without paying brokerage. However the documentation and process is so complex some shareholders throw their hands in the air.

Hopefully that will not be the case any longer. By the end of this article all shareholders should be encouraged to read the documentation and calculate whether the buyback is compelling for their own circumstances.

To gain some perspective, one can look at what the company is trying to achieve. It wants to reduce capital by returning it to shareholders. If it makes a proportional offer, there will be some shareholders who wanted to increase or maintain their holding (by value), while others who wanted to sell a greater quantity of shares will continue to sell on market. With a tender only the willing sellers will sell – they may even be willing to pass on part of the brokerage saving! Taking sellers out of the market can benefit the share price temporarily as the ratio of sellers to buyers drops, and there will also be a permanent enhancement of earnings, cash flow and net asset backing per share, due to the lower number of shares on issue.

The company would be wise to pay as low a price as possible to buy their shares back – but how is this fair to shareholders? The company provides the shareholders with equal information and asks them to choose a price they will be happy with. If we think of this as a reverse auction, you can appreciate that the greater the 'demand' to sell, the lower the price of the buyback. For example, if most of the shareholders tender their shares for sale at the lowest price in the range, that is where the final price will be set. The company will discard all bids above the lowest

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price and accept all or a proportion of the bids at the lowest price or 'final price'. If a small percentage of shareholders tender at a variety of prices, the company may accept all the bids, buying back the shares at the highest price in the range in order to return the entire sum set aside for this purpose.

If everyone calculates an appropriate price then the tender should appear fair because shareholders have chosen at which price they wish to participate.

So how does one do that? As you could otherwise sell the shares on the market, we look at the current market price as a benchmark. If you were planning to sell your shares anyway, you need to use the market price less any brokerage (calculated on a per share basis). At this price you would be indifferent to selling on market or through the tender. If you need to reinvest your funds and were not considering selling this holding you need to take into account the brokerage associated with the subsequent purchase (as your alternative is do nothing). You also need to factor in the timing risk (that your alternative investment, share price moves up while you wait for the tender outcome).

Be aware that some large holders may have wished to sell when the offer was made. They may calculate the market price would fall by 10% or more if they sold on market and bid a lower price than retail shareholders expect. It is this risk that leads me personally to prefer to set a minimum price rather than to leave the final price to be decided for me.

The final price will be set at the level which 'clears' the buyback amount. If demand is high, the price will be low and if many shareholders have bid the same price (or not set a price) there will be a scaling-back as described in the documentation. If demand is low the price will be higher. If you have set your price appropriately you should be indifferent to whether you were successful or not, although the uncertainty as to what price and how many shares you will sell can be difficult to tolerate. You may want to place a value on the uncertainty and add that into the calculation or decision to participate.

What really makes buybacks complex is the inclusion of a franked dividend in the payment so that the capital payment and consequently arising capital gains tax is reduced. Therefore the share price participants are willing to accept is also reduced.

In this case, the company is distributing franking credits to shareholders in a way that makes the people who value them more, pay for them. To calculate a bidding price, you now need to take into account the difference in after-tax price for the buyback and the share market, including the benefit of franking. There is no easy mental calculation for this – you need to write it all down.

Firstly, write down the deemed capital component and your cost base. At this stage, you will note the documentation will contain a comment about recent changes to tax rules, which may affect the capital price amount. Ideally you would factor this in but there is no way to reliably estimate the price change before it happens so expect to be incorrect by a margin and leave it out. Calculate your capital gains tax for a buyback or market sale (remember your own circumstances may mean you have asset and income limits to take into account). You may even find you have a capital loss to offset against current or future capital gains. Then add the after-tax franked dividend.

It is where the franked dividend is a high proportion of the buyback price that the final price can be surprisingly low as the capital gains saving can be substantial.

Yes, the situation is complex but if you step through the calculations, at least you will have an idea of what share price would be fair for you and lodge your tender on that basis.

EXAMPLE: Company XYZ

Buyback range: $0.50 - $1.00
The context: To hold this share as part of the portfolio.
The calculation:

Cost Base	$0.50
Market Price	$1.00
Number of Shares	1,000
Brokerage	$30.00
Tax Rate	30%

If I sell on market I will receive $970 of which $470 will be taxed at say 15% (as I held the shares for 4 years). So I receive $899.50 or $0.90 if I sell on market.

Share Buyback includes $0.50 fully franked dividend. If the buyback is struck at $1.00 I will have a nil capital gain and a dividend with the tax already paid – I will receive $1,000. If I want to buy another 1,000 shares I will need to pay $30 brokerage. So I deduct the $30 brokerage from the $1,000, and compare the $970 with $900 available from selling on market, leaving a $70 profit from the transaction. I have also reset the cost base to $1.00 for any future sale of the shares. Now I need to think about whether this is worth the effort and uncertainty. I may be scaled back, the market may move upward in the meantime. What will I do?

SAMPLE OF RECENT OFF-MARKET SHARE BUYBACKS

Date	Company	Price Range $	Market Price $	Final Price $	Franked Dividend $	Capital Repaid $	Scale-back
3/10/03	Telstra	4.20 - 5.40	4.80	4.20	2.70	1.50	High
6/11/03	Fosters	4.00 - 4.90	4.40	4.00	1.81	2.19	Nil
5/5/04	Westpac	14.00 - 18.00	17.92	Not complete	Final Price less capital repaid	4.00	na
9/6/04	IAG	4.00 - 5.00	4.77	Not complete	Final Price less capital repaid	1.78	na

The uncertainty of share buy-back tenders

Last month in our feature article on share buy-back tenders we dismissed the impact of Australian Taxation Office Taxation Determination 2004/22 on the grounds it could not be assessed at the time of calculating the value of the buy-back. Since then the outcome of the Westpac and IAG tenders and the deemed capital proceeds have been revealed.

The size of the adjustment highlighted the fact that while the amount is uncertain the impact can be significant. Hence a greater level of uncertainty needs to be factored into any decision to participate. We understand that this article is of a more technical nature than last month but this is necessary due to the subject matter.

The ATO introduced TD 2004/22 to calculate the market value of a share at buy-back time. Prior to a number of buy-back tenders, which resulted in low capital values, the ATO had accepted that the tender result indicated market value at the time. Subsequently it emerged that the price may be influenced by the tender participants' circumstances including their calculation of the after-tax value of the buy-back.

The following three numbered points are the elements of TD 2004/22 that are relevant:

1. For off-market share buy-backs of listed company shares the market value of the share for the purposes of subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* (ITAA 1936) at the time of the buy-back should be determined as the volume weighted average price (VWAP) of the company's share on the ASX over the last five trading days before the **first** announcement of the buy-back adjusted for the percentage change in the S&P/ASX 200 Index from the commencement of trading on the **first** announcement date (the Opening S&P/ASX 200 Index) to the close of trading on the day the buy-back closes (the Closing S&P/ASX 200 Index). That is: VWAP over last 5 trading days * (Closing S&P/ASX 200 Index / Opening S&P/ASX 200 Index)

2. The **first** announcement date will be taken to be the first time the company indicated to the market place that the buy-back was in serious contemplation. This may be earlier in time than when the company officially announces the details of the buy-back.

3. The precise calculation of the subsection 159GZZZQ(2) amount cannot be determined until all the relevant information and surrounding circumstances are known, including the final buy-back price. And the above process may need to be varied to reflect circumstances arising during the buy-back period, other than the buy-back itself, that have affected the value of the company's shares such that the S&P/ASX 200 Index adjustment is not reflective of the simulated movement in the company's share price. It may also be the case, depending on who the purchasing company is, that a more appropriate index than the S&P/ASX 200 should be used.

The Westpac buy-back tender range was $14.00 to $18.00. The final price was $14.50, comprising of a fully franked dividend of $10.50 and capital component of $4.00. The deemed disposal price for capital gains tax purposes for shares sold into the buy-back is $7.21 (calculated as the $4.00 capital component plus the difference between the Tax Value of $17.71 and the buy-back price of $14.50).

The IAG buy-back tender range was $4.00 to $5.00. The final price was $4.40, comprising of a fully franked dividend of $2.62 and capital component of $1.78. The deemed disposal price for capital gains tax purposes for shares sold into the buy-back is $2.16 (calculated as the $1.78 capital component plus the difference between the Tax Value of $4.78 and the buy-back price of $4.40).

Why were these adjustments of different sizes when the tender closed on the same date? The graph below shows how the share prices traded from announcement of the buy-back on 26 February for IAG (the lowest line) and 5 May for Westpac (top line) and the movement in the S&P/ASX 200 index (middle line).

As can be seen, the S&P/ASX 200 index has risen over the period of each tender so the multiplier of the VWAP is greater than 1 (roughly 1.05). So how can we take the adjustment into account when we are calculating whether or not to participate in the tender? We can calculate the known amounts and then express the outcome as a price plus or minus the possible impact of the change in the index. Page 21 of the IAG buy back booklet and Page 19 of the Westpac buy back booklet indicated the VWAP ($4.51 and $17.11 respectively). However the change in the S&P/ASX index over the buy-back period added $0.28 cents to the IAG VWAP and $0.60 to the Westpac VWAP. This is a sizeable increase in the capital proceeds per share and consequent tax payable with the market moving upward by approximately five per cent. Regrettably, the uncertainty caused by the operation of TD 2004/22 denies you the opportunity to establish whether you will be better off selling on market than in the tender with any accuracy.

Is the uncertainty removed if the tender price is greater than the market value of the share? If there is a dividend component there is no deeming of the purchase price but the amount the purchase price is greater than the market value of the share is considered unfranked. So a different area of uncertainty is introduced.