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The Board of Taxation
C/- The Treasury
Langton Crescent
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By email: taxboard@treasury.gov.au

Dear Mr Warburton

Board of Taxation Review of the Taxation Treatment of Off-Market Share Buy-Backs

Ernst & Young is pleased to provide this submission in response to the Board of Taxation ('the Board') discussion paper titled 'Review of the taxation treatment of off-market share buy-backs' issued on 16 July 2007 ('the discussion paper').

Off-market share buy-backs represent an important capital management tool for Australian companies, which contributes to their financial development and growth. The practices are consistent with the current tax legislation, as our submission demonstrates.

The taxation treatment of off-market share buy-backs should, in our view, be aligned to the underlying policy for refundable franking offsets, the treatment of cash dividends or dividends reinvested under dividend reinvestment plans.

In our view, before any proposals to alter the fundamental nature of off-market share buy-backs are contemplated, a number of policy decisions must be clarified by the Government including its policy on dividend imputation and refundable franking offsets particularly for tax exempt Australian shareholders. Absent a decision by government to alter its policies there is no compelling case for fundamental change.

The rules for administrative and operational aspects of off-market share buy-backs should, however, be improved to reduce the uncertainty, delays and costs involved. Selective legislative changes might allow the mechanisms to operate more efficiently. However it is critical that these modifications allow significant flexibility for companies and their shareholders, rather than introducing a prescriptive mechanical outcome for off-market share buy-backs, which will not meet all circumstances.

Our submission focuses on off-market share buy-backs undertaken by listed companies. There are different drivers for the use of off-market share buy-backs by unlisted companies as compared to listed companies, as noted in the discussion paper, including different shareholder profiles (with fewer tax exempt shareholders) and objectives to be achieved by undertaking a buy-back. The policy and taxation treatment of listed companies should be settled before unlisted company issues are considered.

Should you have any queries in relation to this submission would you please contact in the first instance Greg Pratt on (02) 8295 6095, Patrick Broughan on (03) 9288 8830 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Greg Pratt
Partner

Review of the Taxation Treatment of Off-Market Share Buy-Backs
Ernst & Young Submission

For convenience this submission is laid out in a manner broadly corresponding to the chapter headings in the Board of Taxation discussion paper of July 2007 ('the discussion paper').

Executive Summary

In our view, before any suggestion is contemplated about fundamental changes to the taxation treatment of off-market share buy-backs, a number of policy decisions must be clarified by the Government including its policy on dividend imputation and refundable franking offsets, particularly for tax exempt Australian shareholders.

In our view the taxation treatment of off-market share buy-backs appears to be in line with the policy for refundable franking offsets. The treatment of off-market share buy-backs should also be consistent with the treatment of cash dividends or dividends reinvested under dividend reinvestment plans. It would be a major policy departure to align the taxation treatment of off-market share buy-backs to that of sales of shares or on-market buy-backs, and we note that the Ralph Review of Business Taxation (RBT) favoured continuation of the present treatment which is aligned to the relationship which a company has with its shareholders under the dividend imputation system.

After the policy has been clarified or resolved, the rules for administrative and operational aspects of off-market share buy-backs can be improved to reduce the uncertainty, delays and costs involved. Selective legislative changes might be made to cause the mechanisms to operate more efficiently. However it is critical that these modifications allow significant flexibility for companies and their shareholders, rather than introducing a prescriptive mechanical outcome for off-market share buy-backs, which will not meet all circumstances.

Employee share scheme arrangements should not be subject to the off-market share buy-back rules of Division 16K and a broader definition of employee share arrangements will be required.

The Board should consider possible changes to the taxation of off-market share buy-backs that might reduce the distortion preventing equal participation in off-market share buy-backs by listed investment companies, in consultation with these entities, so that they might participate in off-market share buy-backs.

It is important that any changes which might be made to the taxation of off-market share buy backs should not lead to any reduction in the international competitiveness of Australian companies.

Our submission also comments on a number of other issues including:

- Factors which led to increased use of off-market share buy-backs and current corporate use;
- Capital/dividend split and equality issues; and
- The use of the Part IVA anti-avoidance provisions.

Background of Government Policy Needs to be Clarified

Reference: Board's questions 2.4 – 2.7

In our view, the debate about off-market share buy-backs is largely based on misconceptions, which have developed in the absence of clearer guidance from parliament and the Australian Taxation Office (ATO) about the policy underpinnings of the dividend imputation system. Lack of clarity in the legislative process has contributed to some uncertainty and hesitancy on the part of the ATO, and has certainly led to misconceptions among some commentators unfavourably disposed to off-market share buy-backs.

We agree with the Board that when evaluating the current tax treatment of off-market share buy-backs and alternative options for reform it is appropriate to apply the broad policy objectives of the tax system. So it is important for the Board to consider the extent to which it is possible to alter the current tax treatment of off-market share buy-backs in a manner that improves the ability of the tax system to raise revenue in a more efficient and equitable manner.

However, it is also essential for the Board to consider:

- the policy objectives underlying the current tax treatment of off-market share buy-backs and its integration into the dividend imputation system and related parts of the tax system, which include the tax treatment of on-market buy-backs, dividend distributions and capital gains; and
- the extent to which the current tax treatment of off-market share buy-backs is consistent with those objectives.

We recognise that, although it is easy to identify the broad policy objectives of the tax system, it is more difficult to identify the fundamental policy objectives underlying the various regimes that comprise the tax system, because the design of the various components of the tax system inevitably requires governments to make complex trade-offs between the conflicting objectives of the tax system and those trade-offs are often not well documented.

This means that when evaluating the current tax treatment of off-market share buy-backs and alternative options for reform, the Board must:

- identify the key trade-offs that have been made by the Government to date in the determination of the current tax treatment of off-market share buy-backs and related aspects of the tax regime, including the dividend imputation regime and the capital gains tax regime; and
- re-evaluate the extent to which the "balance" struck by these trade-offs is still appropriate.

We recommend that before any modifications to the tax rules governing the taxation of off-market share buy-backs can be made, the Government must clarify its policy, in particular in respect of the interaction of the imputation system including refundable franking offsets and Australian shareholders having different tax rates and tax exempt shareholders.

This clarification is necessary because off-market share buy-backs represent merely a commercial application of the dividend imputation system in respect of a particular capital management technique. Some policy issues are discussed below.

Trade-off between protecting the tax revenue base

We believe the Board should reconsider the comments made in the discussion paper and re-examine the trade-off that has been made to date between protecting the tax revenue base on the one hand and economic efficiency on the other. In recent discussions about off-market share buy-backs, too much attention has been placed by those commentators seeking to change the tax treatment of off-market share buy-backs on protecting the tax revenue base through the implementation of specific anti-avoidance provisions and too little emphasis has been placed on the total tax policy underlying dividend imputation and our business tax system, and the adverse impact that legislative and administrative restrictions have on economic efficiency.

While recognising the need to protect the revenue base, we question how efficient and equitable it is for the ATO to attempt to use specific anti-avoidance rules to reduce the extent to which taxpayers are able to use off-market share buy-backs to arbitrage the benefits arising from the Government's decision to apply different rates of tax applying to income in the form of dividends, interest and capital gains.

The alignment of off-market share buy-backs with dividends is the result of complex trade-offs that have been made by the Government. Once those trade-offs have been made it is potentially inefficient and inequitable to attempt to constrain share buy-backs in an attempt to prevent taxpayers from taking advantage of those differences in tax treatment in bona fide commercial transactions. Although such restrictions might raise additional tax revenue, we question whether those restrictions align with the underlying tax policy and whether this represents the most efficient and equitable method of raising that additional tax revenue.

The anti-avoidance rules that are applied in relation to off-market share buy-backs also tend to reduce economic efficiency by increasing the uncertainty surrounding the tax treatment of these buy backs, thereby increasing compliance costs for taxpayers and administrative costs for the ATO. As discussed below, we believe that the best approach to reducing this uncertainty is for the Board to concentrate on the development of "safe harbour" rules that could be incorporated in legislation thereby protecting the tax base while providing companies with the certainty they need.

There are two major issues to which the Board should give significant weight when evaluating the balance that has been struck to date between protecting the tax base on the one hand and economic efficiency on the other:

- First, over the last decade there have been significant reductions in the statutory marginal rates of tax imposed on the income that both resident and non-resident shareholders derive from their investments. This has reduced the extent to which resident and non-resident taxpayers can benefit from imputation credit streaming and other techniques for arbitraging differences in the rates of tax imposed on different forms of income. In other words, there is less arbitrage among domestic shareholders than might previously have been the case;
- Second, as discussed further below, parliament recently introduced express measures to allow shareholders on low and nil tax rates to receive refunds of excess imputation credits. This has further reduced the incentive for companies to engage in imputation credit streaming. More importantly, there is a clear parliamentary evidence of changed tax policy, to reduce or indeed eliminate the previous wastage of franking credits in respect of resident shareholders.

These factors should have significant influence, in our view, on the Board's conclusions.

Recommendation

Clarity is needed in relation to the policy of the income tax rules governing the taxation of off-market share buy-backs, in a legislative form. That legislation can be quite short and targeted and, once that clarity or confirmation is provided, then most of the features of off-market share buy-backs can continue to be managed using administrative processes, as we outline in this submission.

We think it unnecessary to have lengthy legislative change in this area, and we identify the targeted legislative clarifications needed.

Dividend imputation results in different outcomes for shareholders having different tax rates

Since dividend imputation was introduced, various classes of shareholders have had different tax outcomes from their dividends, and different economic outcomes. Dividends result in different consequences for individuals on high tax rates and on low tax rates, for superannuation funds and for companies. In common with other aspects of the law there are winners from receiving franked dividends, such as low rate or tax exempt rate taxpayers, and losers being high rate individual taxpayers which must pay additional tax on their franked dividend income.

Low taxed and tax exempt Australian shareholders are clearly entitled to imputation benefits and cash refunds under the refundable tax offsets rules

Australia introduced in 2000 a system for refundable franking offsets (in the New Business Tax System (Miscellaneous) Act (No.1) 2000) to specifically allow refunds of franking credits for Australian investors which have low tax rates or which are tax exempt. So, by express legislative mechanisms, the Australian government provided for refundability of franking benefits arising from franked dividends to such Australian taxpayers.

Parliamentary intent is clear that Australian resident low taxed and tax exempt shareholders do not have wastage of their entitlement to franking benefits

Tax exempt Australian shareholders include a range of parties, ranging from public charitable institutions of a religious, educational or medical nature (such as hospitals, schools, religious orders and their associated educational, social and medical agencies), foundations, private charitable trusts and certain superannuation and life insurance taxpayers.

We note comments in the discussion paper in para 4.29ff. about perceived wastage of franking credits by the so called streaming of credits as an issue for Government policy. However these comments need careful analysis as they may lead to misinformed policy consideration.

Australia's imputation system clearly involves wastage of franking credits in relation to dividends paid to non-residents. That has been a pervasive feature of the imputation system and we do not question that policy.

However this does not justify enforcing wastage of franking credits in relation to Australian low-taxed or tax exempt shareholders. We note that:

a) The Ralph Review of Business Taxation recommended that Australian shareholders should be entitled to refunds in relation to imputation benefits in excess of their own tax payable in relation to franked dividends. Recommendation 11.7 suggested this be limited to taxable Australian investors and to trust 'donations' to registered charities.

b) The Parliament introduced in 2000, through New Business Tax System (Miscellaneous) Act (No.1) 2000 an express measure to provide for refundable franking credits for a wider group of Australian investors.

So any suggestion that current policy is for wastage of imputation benefits flowing to Australian investors in relation to franked dividends appears to be inconsistent with the actual policy.

Recommendations

Before any consideration is given to modifying the taxation of off-market share buy-backs on the basis of creating wastage of franking credits for resident Australian shareholders, the underlying policy issues relating to the refundable franking offsets provided to low-taxed and tax exempt participants need to be reconfirmed.

After the entitlement of tax exempt Australian investors to franking benefits has been confirmed then, to the greatest possible extent, the approach in relation to deemed dividends (such as those involved in off-market share buy-backs) should be consistent with the treatment of cash dividends or dividends reinvested under dividend reinvestment plans. We emphasise that in relation to cash dividends, under express legislative measures:

a) the dividend imputation system provides refundable franking credits;

b) the refundable franking credits provide favourable outcomes for complying superannuation funds, individuals on low marginal tax rates and certain entities which have a zero rate of tax (following policy consideration including policy issues for charities).

We are not attracted to special limitations on franking benefits in relation to off-market share buy-backs as these would tend to add distortions to the efficient management of franking accounts.

Efficient operation of Australia's companies and development of strong financial position is a policy objective

The policy for the use of off-market share buy backs must also be weighed against issues of best allocation of company resources, market flexibility and other investment issues including the economic impact from any change in investor behaviour.

As discussed below, the current market practice of tendered off-market share buy-backs means that the value of the franking credits attached to the dividend component is to a significant extent retained by the company to the benefit of the continuing investors in the company.

The dividend imputation system encourages Australian companies to pay tax, to the benefit of the Australian revenue. If the companies pay cash franked dividends, the franking benefits attributable to the franked dividends would cause lower taxes to be paid by the Australian recipients of the dividends.

Off-market share buy-backs cause the same benefit to arise for the shareholders, except that the tax benefits are shared with the company undertaking the off-market share buy-backs, due to the operation of the tender system.

We agree with the concerns in the discussion paper about the accuracy of the claimed revenue cost from off-market share buy-backs (this is discussed below in more detail) and we question whether such revenue cost is significant enough to warrant restricting an efficient mechanism for managing Australian companies' capital. We comment below on Treasury's costings included in the discussion paper at table 4.2.

Review of Business Taxation: Aligning Treatment with On-Market Share Buy-Backs

Ernst & Young agrees with the general conclusions reached by the RBT in 1999 (adoption of the second option in "A Platform for Consultation" in recommendation 12.20 of "A Tax System Redesigned") that:

- the current tax treatment of on-market share buy-backs is inappropriate to the extent that it results in the over-taxation of returns to shareholders.

- In particular, it has the potential to double tax the returns shareholders derive from the capital they have invested in the company – that is, capital gains are taxed once in the hands of the company when they are earned and again on distribution to shareholders through on-market share buy-backs. In addition, the current tax treatment also has the potential to tax returns of capital to shareholders. Taxing the return of equity is not a feature of an income tax regime. Even a full accruals capital gains tax does not involve the taxation of the return of equity. It only taxes the return on equity as it accrues. Rather, taxing the return of equity amounts to an assets or wealth tax. Both the double taxation of capital gains and the taxation of returns of capital tend to reduce economic efficiency by:
  - discouraging investment through companies; and
  - distorting corporate decisions regarding the best manner in which to return equity and distribute income to shareholders;
- the current tax treatment of off-market share buy-backs is appropriate, subject to the manner in which the relative proportions of profit and capital in the buy-back are determined. It allows companies to return capital to shareholders free from tax and avoids the double taxation of distributions of income in the form of capital gains. This is outlined in the discussion paper.

As a result, we do not believe that it would be appropriate to align the current tax-treatment of off-market share buy-backs with that applying to on-market buy-backs. It is essential to recognise that the current tax treatment of on-market share buy-backs:

- is the result of trade-offs that have had to be made due to practical constraints;
- recognises that shareholders selling on-market cannot be expected to know that it is the company that is purchasing the shares they are trading on-market and must have certainty, instantaneously, in relation to their sale transaction. The nature of a sale on the stock markets is not consistent with consideration of other tax issues; and
- the result of this trade-off is an inefficient treatment of income and capital distributed through that on-market share buy-back, a treatment inconsistent with the fundamental objectives of the imputation system, to align company and shareholder taxation in relation to company income.

The decision to make in the off-market share buy-back trade-off is not to extend this inappropriate on-market buy-back treatment to off-market share buy-backs. While this might be thought superficially to improve efficiency by reducing the difference in tax treatment of off and on-market share buy-backs, this gain in efficiency is likely to be more than offset by the resulting reduction in efficiency arising from further deterring investment through companies and its inconsistency with Australia's dividend imputation system. Such an approach would need to be justified in terms of its departure from the RBT extensive analysis.

We believe the preferable approach to this problem is to explore options for:

- reducing the extent to which on-market share buy-backs result in the double taxation of capital gains and tax the return of capital (e.g. through relief at the corporate level); and
- improving the efficiency of the current tax treatment of off-market share buybacks.

Government policy clarification will inform any legislative reforms and ATO practice

The outcome of the Government's policy decisions on these matters, which should ideally be expressed in a legislative form, will provide a framework for making recommendations concerning the taxation treatment of off-market share buy-backs.

We submit that the legislative reform should include, at minimum, moving certain relevant rules from Section 177EA, which is part of Part IVA, the general anti-avoidance regime. It is inappropriate for the ATO to administer Government policy by using the anti-avoidance rules. If the outcome that the ATO is trying to achieve by using the anti-avoidance rules is the Government's policy, then that policy should be in the tax law relating to the simplified imputation system. This is discussed further below.

Recommendations

It is important for the Government to clearly state its policy in relation to off-market share buy-backs in a legislative form, rather than the ATO administering the law based on its understanding of the policy, and facing criticism by some.

We submit that the legislative reform should include, at minimum, moving certain relevant rules from Section 177EA, which is part of Part IVA, the general anti-avoidance regime. It is inappropriate for the ATO to administer Government policy by using the anti-avoidance rules. The rules should be in the tax law relating to the simplified imputation system.

As well, section 204-30 and other provisions should be harmonised to ensure clarity of parliamentary policy in order to allow the ATO to administer the law in accordance with clear policy.

Factors Which Led to Increased Use of Off-Market Share Buy-Backs

Reference: Board's questions 2.1 – 2.3

Legal climate and conditions in Australia

Prior to 1989 Australia companies were prohibited from undertaking share buy-backs. In 1989 the law was amended to allow share buy-backs but restrictions were still relatively heavy, 'the law could only be described as very rigid regulation of buy-backs consisting of 37 pages of legislation and 91 sections regulating share buy-backs' (Lamba & Ramsey 2000 p.1) [1].

At this time, the United States had numerous buy-backs occurring with a much less regulated environment.

In 1995 the legislation in Australia was significantly simplified. For example between 1989 and 1995 30 companies undertook share buy-backs in contrast between 1996 and 1998 over 100 companies announced share buy-back programs. The deregulation eliminated many of the mandatory requirements and simplified the process dramatically. Some of the simplifications were:

- No longer a need for companies to change its constitution for authorisation.
- Directors were no longer required to sign a solvency statement under which they will be held liable.
- A public company may acquire more than 10 per cent of its shares in 12 months provided it obtain at least 50 per cent approval of shareholders.
- An auditor was no longer required to provide a report in relation to a buy-back.
- Selective buy-back shareholder approval was dropped to only 75 per cent of shareholders approval.

Economic motivations of share buy-backs

Motivations for share buy backs are various. Five broad categories to define motivations for share buy-backs will be assessed here:

a) *Excess liquidity (surplus cash effect).*
b) *Capital structure (leverage effect).*
c) *Information signalling (investment effect).*
d) *Wealth transfers (extrapolation effect).*
e) *Miscellaneous motivations (other effects).*

a) Excess liquidity (Surplus cash effect)

Surplus cash could be distributed to a shareholder as a dividend (an ordinary or special dividend), a reduction of capital or a buy-back.

b) Capital structure (Leverage Effect)

Gearing or corporate restructuring via a repurchase is an effective way to reduce equity and change the capital structure of the firm to efficient levels. An important consideration in allowing companies to repurchase their own shares is to allow them to alter their capital structure and meet their capital

[1] Share Buy-Backs: An Empirical Investigation, Asjeet S Lamba and Ian Ramsay, The University of Melbourne, 2000

requirements. Further it is a relatively fast and expedient method in which a firm can affect its capital structure.

A company must consider the liquidity and excess debt capacity of the firm. The sale of an asset or division may have impacts on capital structure but the use of debt to finance a buy-back certainly does. It has two effects on the capital base and decline in equity and an increase in liabilities or reduction in cash.

c) Information signalling (investment effect)

Information signalling is essentially an attempt by management to give information to the market. It can essentially have several signals, depending on the current economic conditions, the current industry dynamics and the interaction these two factors have with the individual company's balance sheets and conditions. The signalling explanation depends on management believing that it has confidential information regarding the company that it believes its' shareholders do not have. They may do this because laws may discourage management from making public announcements.

Mitchell[2] gives a good overview of the issues with management motivations based around information signalling to the market. These include:

- Signalling future expectation (current underpricing)

  This is the signalling of future expectations by management that the share price or the market value of the firm is currently undervalued or that operating performance is about to improve. Management is essentially showing what it believes about the company's potential and therefore risks by purchasing its shares, often above the current market value.

- Limited investment opportunities

  Where a company may have surplus capital and/or cash a buy-back can be used for signalling limited investment opportunities are available. This could be an alternative for more speculative investments or when limited takeover or direct investment opportunities exist.

  It can also signal limited growth opportunities. These could be due to many causes both internally and externally. Internal factors may be the current corporate structure which may limit future growth. Other internal firm based factors may also prevent or slow growth leading the company to repurchase shares and reduce capital instead of investing. External factors might include very costly pricing on alternative investments.

d) Wealth transfers among shareholders (extrapolation effect).

This is more relevant for unlisted companies. There might be an opportunity, using selective buy-backs involving a non-proportional off-market buy-back[3]. If company meets the mandatory guidelines and provisions is can differentiate among different groups of shareholders.

There can be many motivations to remove a shareholder besides those relating to a potential takeover threat. They can be for:

- Repurchase of shares from those who are critical of management.
- To avoid on-market price pressures associated with a large shareholding sale.

e) Overall economic climate

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[2] Mitchell, J.D. & Robinson, P. 1999. Motivations of Australian Listed Companies Effecting Share Buy-Backs. *ABACUS*, Vol.35, No.1 p.92.

[3] Et al p.107

The overall economic climate and conditions can affect the number and types of buy-backs that occur in the market. These conditions could be the growth and investment potential available and permissive in the current market climate, or the future expectations about the market. Industry stage and development, market stage and development and many other numerous considerations that an organisation considers regarding the economic climate are all factors influencing share buy-backs.

f) Administrative burden on share registry

Companies that have large shareholder registries will often have unmarketable parcels of shares held by shareholders. Often companies may look to decrease the administrative burden these relatively small unmarketable and small shareholdings have. Buy-backs can also restructure the share registry.

Corporate Use of Off-Market Share Buy-Backs

Reference: Board's questions 2.1 – 2.3, 4.3-4.6, 5.1 – 5.22

Why companies use off-market share buy-backs

In our experience, the use of off-market share buy-backs and their growth in popularity is driven by the continuing success of companies in using this tool to meet their capital management and shareholder value creation objectives.

We agree with the Board's assessment that off-market share buy-backs allow companies to:

- return excess funds to shareholders that might otherwise be used in less efficient ways by companies, including for example in under-performing businesses;
- adjust their capital structure by altering their debt to equity ratio, now considered to be even more important in the recent private equity environment;
- increase earnings per share ('EPS') on a sustained basis; and
- create shareholder value from their stores of franking credits that might otherwise not be distributed to their shareholders.

Off-market share buy-backs are preferred to the alternatives

Off-market share buy-backs allow companies to achieve the above objectives in an efficient way (assisted by the use of the tender process).

The alternatives noted by the Board to off-market share buy-backs are not seen to achieve these objectives as efficiently. For example:

- on-market share buy-backs are more costly to the company than off-market share buy-backs because the company is required to pay full market price for the shares and is subject to market dynamics in executing the buy-back;
- special dividends similarly have no tender process attached and thus there is no ability for the company to benefit from the franked nature of the special dividend. This has the result that special dividends, comparatively, dilute EPS (earnings per share) because the special dividend is funded by debt;
- companies are cautious when considering increasing their ordinary dividends because the markets do not recognise increases in ordinary dividends or franking percentages by a directly correlated increase in the share price. Off-market share buy-backs do not replace increases in corporate dividend policy where the companies have sustainable increases in their underlying income; they merely replace one-off dividends in particular cases.

There are a number of other issues relevant for companies concerning the use and availability of the off-market share buy-back provisions.

The ability of companies, which have paid company tax and created franking credits, to create value for their continuing shareholders from those franking credits rewards the companies' payment of tax and encourages Australian companies to pay company tax. It is a behavioural stimulus for companies to pay tax in Australia.

Equity and benefits are achieved for all shareholders, not just the participating shareholders

Reference: Board's question 5.13

Under the tender process the company is able to recover, from the relevant shareholder participating in the off-market share buy-back, some part of the value arising from the franking credit by virtue of the shareholder being willing to accept a lesser price for their share on the off-market share buy-back transaction.

It is beyond doubt that this value retention in the company is to the benefit of the continuing shareholders in the company which are not participating. in the off-market share buy-back. This is confirmed by company directors and by the corporate regulatory agencies.

However this benefit to the company and its continuing shareholders is limited by the arbitrary maximum discount typically placed on off-market share buy-backs by the ATO. So the ATO 'discount caps' in fact disadvantage the continuing shareholders and create an inequity.

The maximum discount 'cap' restricts equity for non-participating shareholders

Reference: Board's question 4.2-4.3

The ATO approach of imposing a maximum discount on the off-market share buy-back purchase price represents a loss of value to the company and the continuing shareholders.

It might be suggested that the maximum discount ensures that at least one category of taxable Australian investors, namely superannuation funds taxable at 15%, remain competitive in relation to off-market share buy-back activity. It might be argued that, without the discount cap, that tax exempt shareholders would tender a higher discount and would eliminate the scope for participation by lower-rate taxable shareholders. However that is not clear as it is not known what the relative importance is of tax exempt shareholders in Australia's capital market. Further, it is not known whether removing such restrictions would positively impact the use of off-market share buy-backs.

We consider the 14% discount cap further below. We note however that the deregulation of company law to allow off-market share buy-backs in their current form has been, at least to some extent, subverted by the ATO's approach to applying this discount cap as well as restricting or modifying companies' use of share buy-backs by applying or threatening to apply other taxation laws.

Implications of the Current Treatment of Off-Market Share Buy-Backs

Employee share acquisition schemes

Reference: Board's questions 4.7, 4.8

We note that employees engage with off-market share buy-backs where:

- their shares or entitlements are affected by a general off-market share buy-back; or
- where an off-market share buy-back is executed in relation to the employee shares only.

Off-market share buy-backs are also used by companies to manage their employee share acquisition schemes (ESAS).

A difficulty in this regard is that the term 'employee share schemes' applies only to those schemes subject to Division 13A, but Division 13A applies only to employee shares acquired at a discount and there are many bona fide arrangements where shares are acquired at market value (for example, shares funded by concessional loan arrangements). As a result, there is no single defined term in the ITAA 1936 or 1997 that covers all employee share arrangements.

Employees participating in buy-backs

The discussion paper sets out at Appendix H scenarios where in relation to discounted shares where the share buy-back tax rules result in a greater amount of taxable income to the employee than if the shares were sold to a third party. Whether or not the employee pays more or less tax, and is therefore better or worse off, will depend on the availability of franking credits. Arguably, employee shareholders, who, as a generalisation, are probably not as financially aware as ordinary shareholders, should not be put in the position of having to work this out. A similar problem arises for employees who may want to exercise options to sell into a buy-back and the dividend component of the buy-back exceeds the exercise discount.

A double counting issue arises also. If disposal restrictions need to be released (thereby resulting in a cessation event under Division 13A) more than 30 days prior to a buy-back occurring, the employee then pays tax under Division 13A on the discount at cessation and then again on the dividend as a result of the buy-back.

Where buy-backs relate only to ESAS schemes

When considering share buy-backs to facilitate the operation of employee share plans, tax challenges arise. This often means that companies must establish trusts to hold and retain shares, when buy-backs could be administratively far simpler.

Section 45B appears to have significant application to off-market share buy-backs of ESAS shares. If the total amount of such buy-back is debited to share capital the ATO could seek to apply the anti-avoidance rules relating to capital streaming, which have a low threshold for application of a ‘more than an incidental purpose’. This would appear not to be an appropriate outcome and should be clarified.

Where an employee has a share entitlement subject to vesting or performance conditions which are not achieved, the shares must be forfeited and the employee realises neither a loss nor a gain. If this transaction is structured as a buy-back, the employee would be forced to recognise a dividend component as income, notwithstanding the transaction is otherwise neutral. As a result, employers are forced to establish trusts to act as a purchase and temporary holding vehicle for shares in such circumstances in order to avoid the unfavourable tax outcomes that apply under the buy-back sales.

Unlisted companies also have employee share plans and, when an employee leaves the company, they are required to sell their shares. An administratively simple mechanism to achieve this would be to buy back the shares at the agreed price. However, under Division 16K in its current form, this would result in a component of the consideration being taxed as a dividend rather than capital gain, with the employees potentially worse off. As well, the employer potentially needs to obtain a ruling from the ATO every time, in order to establish with certainty the dividend component.

Recommendations

Employee share scheme arrangements should not be subject to the off-market share buy-back rules of Division 16K.

As noted above, a broader definition of employee share arrangements than the current definition will be required.

Implications and Cost to the Revenue From Off-Market Share Buy-Backs

Reference: Board's questions 2/4 – 2/7, Discussion at paras 4.29ff.

We note comments in the discussion paper in respect of the Treasury calculation of the cost to the revenue from off-market share buy-backs, the application of section 177EA in respect of non-residents and some practical issues concerning any domestic streaming adjustments.

The discussion paper includes a table 4.2 on the cost to revenue from off-market share buy-backs. We, share the Board's concerns about the completeness of the costing and the concerns expressed by the Board in paras. 4.29ff. and highlight:

- Is there an estimate of, or discussion of, the effect of franking debits made by the ATO in respect of corporate franking accounts where off-market share buy-backs involve distributions to non-resident shareholders?
- Is there any discussion of the trade off concerning the increased company efficiencies from the use of off-market share buy-backs? It appears to us that the effect of tendered off-market share buy-backs, instead of a large special dividend to shareholders, is to enhance the position of the company as compared with it having made a cash dividend. The off-market share buy-backs therefore enhance the company's income from the reinvestment of those funds (as distinct from the cash dividend which would have resulted in the relevant earnings having been generated by the shareholders and taxed at individual, super fund or tax exempt shareholder rates).
- Is there any discussion of the potential for there to be increased tax collections as a result of non-participating shareholders selling their shares after the buy-back has been completed? There is evidence that the company's share price increases after the buy-back has been completed to reflect the EPS benefits the buy-back delivers. If investors realise this increased value through a sale of shares, there would be higher tax collections than if the buy-back did not occur.

We note that any cost to revenue would be different if there was a more limiting discount cap applied (because the amount of franked dividend would be higher) or if there was no discount cap (because the amount of franked dividend would be lower).

Role of Fund Managers - Equity for Listed Investment Companies

Reference: Board's comments at 4.21, questions 4.4-4.4

Australia has introduced a specific form of company, the Listed Investment Company (LIC) which is a listed company having many of the characteristics of a managed fund or trust. LICs are important participants in Australia's capital markets and in investment in other Australian listed companies.

Recommendation

The Board should consider possible changes to the taxation of off-market share buy-backs that might reduce the distortion preventing equal participation in off-market share buy-backs by LICs, in consultation with these entities, so that they might participate in off-market share buy-backs.

If a LIC participates in an off-market share buy-back, a LIC (like any other company) can not crystallise a capital loss in a share buy back where the total buy back consideration is more than the reduced cost base of their shares (due to the effect of sub-sections 159GZZZQ(8) to (9)). This rule was added shortly after the introduction of Division 16K in relation to the inter-corporate dividend rebate that operated at that time. The reference to dividend 'rebatable amount' was replaced with the current 'offsettable amount' reference as a consequential amendment when the imputation provisions were re-written. No explanation for the continuation of this rule was given in the Explanatory Memorandum ('EM') to the Bill that made this change.

If LICs and other companies were entitled to capital losses they would prima-facie receive a greater benefit from an off-market share buy-back than they currently do. The extent of the increased benefit will of course depend on various factors and we note however that this capital loss might not be attractive to LICs as distributions of capital gains by LICs may be concessionally taxed.

Alternatively, removing the ATO's 14% discount cap might compensate LICs as a continuing shareholder in investee companies by allowing investee companies to maximise the value of their excess franking credits by potentially buying back their shares at a lesser amount, thereby achieving greater EPS benefits and enhancing the position of continuing shareholders not participating in the off-market share buy-backs.

Role of Fund Managers - Managed funds

Reference: Board's comments at 4.21, questions 4.4-4.4

We understand that managed funds that report on a pre-tax basis also do not benefit particularly from off-market share buy-backs. Investors in managed funds do benefit from franked dividends flowing through to unit holders, and the losses involved offset against other gains of the fund. So there is recognition of the outcome of off-market share buy-backs although there is no formal financial reporting of the precise effect on the increased performance for the fund. As to whether this represents some significant competitive disadvantage, we recommend that the Board should consider consulting separately with the funds management sector in this regard.

A comment is made at para 4.21 of the discussion paper about the difficulties for funds managers in relation to larger superannuation funds and their participation in off-market share buy-backs. Larger superannuation funds increasingly engage with their funds managers directly, using contractual mandates, rather than using managed funds which are more directed to retail or smaller investors. Where larger superannuation funds use such mandates, the commercial arrangements are structured from inception, or varied, to enable the funds managers to appropriately invest in attractive off-market share buy-back situations.

Administration Issues

Reference: Board's questions 5.35, 5.36

As the discussion paper and ATO practice statement make clear, there is very extensive ATO regulation of off-market share buy-backs.

The key challenges however are:

- Delays in negotiating with the ATO the various specific circumstances in relation to each off-market share buy-back;
- The lack of transparency, in the period until the recent ATO practice statement, of the mechanism and administrative approaches used. These have been known to us and other advisers in this area but there has been unnecessary mystique and lack of knowledge which has affected the efficiency and speed of execution of off-market share buy-backs.
- The lack of any short-cuts or rules of thumb in relation to the dividend/capital split and the pricing of off-market share buy-backs, to act as a default position or baseline while allowing flexibility for specific, justifiable modifications to be negotiated in particular circumstances.

Recommendations

We therefore recommend that:

a) There should be legislative reform to ensure that the Government policy on dividend imputation and off-market share buy-backs is clear.

b) The legislative reform should not over-regulate off-market share buy-backs by having prescriptive rules setting out single outcomes for all situations involving off-market share buy-backs. There would be significant benefits in the legislation providing default short-cuts or safe harbours in relation to the dividend/capital split and determination of the market value of the share for the purposes of section 159GZZZQ conditional on, in every case, having power for the ATO and taxpayer to agree on a departure from the default position in appropriate circumstances.

   The legislation should clearly authorise the ATO to agree to divergent positions in appropriate circumstances, and should provide relevant factors to be used by the ATO in such determinations.

c) Flowing from the focused legislative actions we submit that the ATO should provide clearer, more practical guidance than set out in the ATO's practice statement on off-market share buy-backs (PSLA 2007/9). That statement, while welcome, and providing assistance in relation to many aspects of off-market share buy-backs, was produced without consultation and there are various aspects that may require further clarification.

   The ATO product should be an ATO public taxation ruling to provide a higher level of certainty, and should contain safe harbours wherever possible, to enable more efficient and speedy compliance with the rules, as discussed above.

d) The Board should confirm with the ATO that it would be willing to prepare binding rulings and determinations in this regard. If the ATO continued to have difficulties with providing clearer guidance then more of the rules should be placed into the legislation.

Trading in company's shares after announcement of off-market share buy-backs

Reference: Board's questions 5.18 - 5.19

A feature of off-market share buy-backs is that investors will buy a company's shares after an off-market share buy-back is announced or foreshadowed. We recognise there is a policy question about the acceptability of allowing investors to enter a company's share register after an off-market share buy-back is announced or foreshadowed. We recognise that there is a concern that such investors may be short-term in nature and may be focused on tax benefits. However we note that:

- Such investors add liquidity to the market and enhance the success of the off-market share buy-back;
- Under the tender process the franking benefits attributable to those investors are shared with the company undertaking the off-market share buy-back; and
- If such investors were not permitted to participate, a similar amount of franking benefits would presumably be utilised by other investors.

It is not clear therefore that, leaving aside the appearance or perceptions arising from such post-announcement trading, whether this represents a problem for the tax revenues of Australia.

Recommendations

Australia's companies need efficient capital management tools, consistent with the policy settings of the imputation system which encourage the payment of company tax.

We do not favour the arbitrary imposition of a 14% cap on the discount which a company can offer its shareholders participating in an off-market share buy-back. If there is a policy concern about the involvement of tax exempt shareholders in off-market share buy-backs, this should be resolved at a fundamental policy level, in a way which is consistent with the treatment of franked dividends paid in cash.

In relation to post-announcement trading in companies which have announced off-market share buy-backs, the policy analysis must consider the liquidity created from this feature. If there was to be any limitation on post-announcement trading, this should be clearly specified in the legislation, rather than being implemented by virtue of the ATO practice which may not be fully supportable by the legislation.

Capital/Dividend Split and Equity Issues

Reference: Board's questions 5.29 – 5.31

Flexibility is very important for the efficient use of use of off-market share buy backs by companies. This includes the flexibility in how the capital/dividend split is determined, to allow a split to be calculated using an average capital per share or a share capital to retained earnings ratio 'slice' approach, or using some other approach as agreed with the ATO.

Although default methods may assist the administration of the rules we note that the average capital per share method, which appears to be the obvious choice for a capital/dividend default method, may not work in all situations, for example, if a company has recently undertaken a scrip-for-scrip acquisition and its share capital has increased substantially.

WE support the need for flexibility of methods. This is recognised also by the ATO in their practice statement, in which they state that there may be occasions when a different approach to the average capital per share method is needed, including the slice approach and an embedded value approach.

One way of reducing the complexity in relation to the use of the three possible methods might be to introduce a rule which allows the percentage of the buy-back price that may be a frankable dividend component to be any value up to a specified limit. The maximum dividend component limit might be 80% of the purchase price for example.

General Anti-avoidance Rule Should Not Apply to Off-Market Share Buy-Backs

Reference: Board's questions 5.20, 5.24

We question the assumption that the use of off-market share buy backs should result in the application of anti-avoidance provisions to compensate the revenue for the avoidance of the wastage of franking credits.

Background to the Australian imputation system and anti-avoidance rules

Australia's imputation system was introduced in 1987 to allow shareholders a rebate for tax paid by a company on profits it distributed as dividends. The rules were rewritten and simplified in a process that began from 1 July 2002.

The imputation system is designed to effectively remove the second layer of tax imposed on income derived by a company that occurs at a shareholder level. The introduction of an imputation system of company taxation in Australia has contributed to the strength of the Australian corporate sector and the growth of the Australian economy including through investment in the corporate sector.

As we have noted above, there were express refundable tax offsets rules introduced at the time, specifically to undo the previous wastage of franking benefits among Australian resident shareholders.

The direct cost of these changes was estimated at $50 million in the year the reforms were passed and $300 million per annum thereafter. The Explanatory Memorandum ('EM') to the Bill did not discuss any inbuilt intended wastage of franking credits in the costings.

Anti avoidance rules do not target, currently, investors benefiting from franked dividends

Section 177EA (ITAA 1936) was introduced in 1998 as a general anti-avoidance rule to apply to schemes to obtain a tax advantage in relation to franking credits (franking credit schemes). The purpose of this provision was explained in the EM to the introductory Bill to be to protect the revenue by curbing the unintended usage of franking credits through such schemes.

In the context of share buy-backs, the ATO's practice statement confirms that the Commissioner will apply section 177EA where a company that engages in a buy-back has both resident and non-resident shareholders. The Commissioner will debit the company's franking account, rather than deny the franking credit to shareholders, by an amount calculated by reference to the franking credits that would have been wasted had they been received by both resident and non-resident shareholders.

The concept of wastage of imputation benefits was also considered in respect of the introduction of the anti-streaming rules in section 204-30 (ITAA 1997), introduced in 2002. The EM to the introductory Bill states that where members hold interests in the profits of a corporate tax entity, the policy is that credits for tax paid on behalf of all members should flow to all members and not to only some of them and that the policy of the tax law assumes that the benefit of imputation will, over time, be spread more or less evenly across members in proportion to their holdings. The EM indicates that situations where corporate taxpayers have excess franking credits that engage in share buy-backs may nevertheless result in streaming, irrespective of there being sufficient credits to frank distributions to other members. However the EM also states:

> 3.30 Thus, streaming is unlikely to occur when a corporate tax entity, in making franked distributions, distinguishes between 2 classes of members, both of which comprise members who can and who cannot benefit from imputation credits. ….
>
> *When does a member derive a greater benefit from imputation credits?*

3.40 For this streaming rule to apply, the recipient must:
receive an imputation benefit; and
because of the nature or status of the recipient, derive a greater benefit from imputation credits than another member who misses out on an imputation benefit.

3.41 Relevant factors in determining whether the recipient derives a greater benefit from imputation credits than another member include:
whether one of the members would not gain the full benefit of the tax offset from the franking credit (e.g. corporate tax entities are not entitled to a refund of excess imputation credits) [Schedule 1, item 1, paragraphs 204-30(8)(b) and (c)];

3.42 A difference in marginal tax rates of members of a corporate tax entity does not, by itself, indicate that some members derive a greater benefit from imputation credits than others. ”

In our view, that Section 204-30 was intended to apply to arbitrage transactions between:

- shareholders which derive benefits from a franked dividend; and
- shareholders which **derive no benefits** from a franked dividend.

As noted in the discussion paper the ATO recognises that this provision may be difficult to apply in the context of differentiating between different Australian shareholders all of which are entitled to imputation benefits and the ATO applies section 177EA instead in cases of dividend streaming.

In 2000 refundable franking offsets were introduced for Australian resident individuals, superannuation funds and other non-corporate entities including charities. This was a significant policy change, the result of which is that all Australian residents now benefit from franking credits whether they can use them to offset tax payable or not.

This change should be considered to have superseded the concerns of franking credit trading schemes in respect of residents, leaving the provisions to potentially apply only in respect of non-residents.

So, from the 1998 introduction of Division 16K and certainly from the 2000 introduction of refundable franking offsets, there is no basis for a statement that wastage of franking credits otherwise available to Australian shareholders is a feature of the Australian imputation system.

We note that the discussion paper refers to section 204-30 and the ATO's approach to applying this provision in its practice statement, in which the ATO states that:

> 141. The Tax Office holds the view that the structure of an off-market share buy-back is a means whereby franking credits may be streamed to resident shareholders as a class, who will receive a greater benefit from franking credits than non-resident shareholders as a class.
>
> 142. The Commissioner will generally not make a Determination pursuant to subsection 204-30(3) of the ITAA 1997 in cases where he intends exercising his discretion under section 177EA of the ITAA 1936.

Section 204-30 is intended to consider schemes whereby one member of a company receives a greater benefit from franking credits than another member of the entity. With respect, we question whether section 204-30 is intended to distinguish between two Australian shareholders both of which are entitled to refundable franking credits.

Use of Part IVA for off-market share buy-backs

Reference: Board's question 5.37

Before the introduction of refundable offsets, section 177EA had a role to reduce schemes to stream franking credits away from charities and other entities that would not benefit from the full amount of non-refundable franking credits. However after the amendments it appears to us that this policy rationale no longer exists or, at the very least, should be rethought.

The basis that the Government's policy for many years has been to protect the revenue and to offset costs of dividend streaming to non-residents by a franking debit then there needs to be mechanism for the ATO to debit a company's franking account for the proportion of buy-back that would otherwise have gone to non-residents.

However we submit that the placement of this 'integrity measure' rule unto the general anti avoidance rule of Part IVA, using section 177EA, is not appropriate.

In our view, the imposition and calculation of any such debit should be specifically integrated into the dividend imputation rules for clarity to operate where the off-market share buy-back provisions of Division 16K apply. The ATO should not need to resort to using a general anti-avoidance rule in relation to conventional capital management techniques.

Recommendations

We recommend that section 177EA should be amended in two respects.

a) to properly reconcile its operation with the refundable franking offset changes so as not to apply to franking credit schemes in respect of resident taxpayers; and

b) to ensure that the ATO power to impose franking debits to companies' franking accounts in respect of distributions to non-residents in relation to off-market share buy-backs is properly stated in the SIS, for example in section 205-30 rather than remaining in the general anti-avoidance rule of Part IVA, in Section 177EA.

International Competitiveness Issues

Reference: Board's questions 5.5 – 5.6

Australian companies should have a tax regime that enables them to be internationally competitive. A measure of international competitiveness should include the ability of Australian companies to manage their capital and to maximise their overall value to shareholders. As discussed above, off-market share buy-backs allows companies to increase earnings per share and manage their weighted average cost of capital in one transaction.

We agree with the Board's assessment that it is difficult to make comparisons of international competitiveness in respect of the taxation and use of share buy-backs. However, whilst other countries do not have Australian style imputation systems many may achieve similar outcomes to those in Australia in different ways.

Approaches in other countries to the taxation of off-market share buy-backs will vary but as shown in the international comparison section of the discussion paper (which was prepared with significant input from Ernst and Young) the result can be similar to Australia in that the components of the off-market share buy-backs may be separated into an income and capital component for taxation.

As noted by the Board, there are a number of ways that other countries may concessionally tax the dividend and capital components of a share buy-back:

- Some foreign jurisdictions tax dividend income and capital gains at concessional rates, including for example, the United States;
- Other foreign jurisdictions provide a notional tax credit for dividend income rather than having full imputation, including for example, the United Kingdom; and
- Some foreign jurisdictions exempt dividends and capital gains from taxation, including for example, Singapore.

Recommendation

It is important that any changes which might be made to the taxation of off-market share buy backs should not lead to any reduction in the international competitiveness of Australian companies.