2 Upper Minimbah Rd
Northbridge NSW 2063
23rd August 2007

The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2000

REVIEW OF OFF-MARKET SHARE BUYBACKS

This submission is in response to the Board's discussion paper ("DP") dated July 2007 and addresses the term of reference *the implications of the current taxation treatment of off-market buybacks for different types of shareholders*

Q4.6. *Why are off-market share buybacks preferred over special dividends for the distribution of volatile profits?*

In addition to the reasons set out in the DP, off-market buybacks deliver better after tax outcomes for all classes of individual shareholders than dividends (ordinary or special).

This may be demonstrated by a model (see attached) which compares the after tax outcomes for different classes of individual shareholders when a company distributes the same amount of cash by way of off-market buyback on the one hand and a fully franked dividend on the other. The post distribution cash position will be identical (comparing apples with apples). The post distribution franking account balance will be higher for off-market buybacks than dividends owing to the capital component (further favouring off-market buybacks if franking account balances are regarded as having any value).

The model shows that if a 14% discount to VWAP is achieved (the usual result in recent years) and 1% of the buyback amount is allowed as the additional costs of distributing via buyback than via dividend, all individual non-participants gain (other than the zero MTR taxpayers who gain via their participation and the 16.5% MTR shareholders who are line ball as non-participants). Individuals on the highest MTR gain most (30%) and the gains decreases as the MTR falls- however even a 31.5% MTR taxpayer will be 12% better off should a company distribute cash by way of an off-market buyback than as a fully franked dividend.

The model also allows the non-participants to sell some shares (and pay the CGT) so the cash in hand position of the non-participating shareholders could be the same as if they had received a dividend. However if the cash is not required immediately, the CGT liability under the buyback may be postponed giving further benefits to the non-participants.

The outcome of the participants in the off-market buyback has not been modeled as experience has demonstrated that zero MTR shareholders enjoy such a benefit from participation that they would happily give up their special dividend for an off-market buyback.

Q5.13 *Do non-participating shareholders benefit from off-market* buybacks?

This response addresses the typical listed company off-market buyback. The company has surplus cash which it wishes to distribute via dividend or some other capital management initiative, the company has surplus franking credits (i.e. the remaining credits and the credits to be generated from future profits will allow future profits to be distributed as fully franked dividends) and there is a reasonable expectation that the tender price will be set at a 14% discount to the tender VWAP.

One can only determine whether a benefit has been created by comparing the after tax outcomes of the alternative distribution strategies under consideration. This can be readily done for all strategies which distribute the same amount of cash.

The attached model demonstrates that provided a discount to VWAP of 14 % is achieved, all non-participating shareholders will be better off under an off market buyback than they would have been had the same distribution been made by way of dividend. So if the franking credits are to be used at all, they should if possible be used in an off-market buyback.

Undistributed franking credits can have no value unless there is some possibility of them being distributed. As they become trapped whatever value they might have had approaches zero and becomes zero on the eventual liquidation of the company. They depreciate with time and earn no income for the company. It is a case of use them or lose them.

Q5.14 Under what conditions would this be the case?

In order to determine whether a benefit has been created one has to compare the off-market buyback result with the alternative strategy (or the most favoured alternative strategy if more than one).

If the alternative strategy is to distribute the surplus cash and franking credits by way of dividend, then an off-market buyback will produce better results for all major classes of individual shareholders.

If the alternative is “do nothing” then one is no longer in a position to compare apples with apples. The surplus cash remains inside the company, the franking credits become trapped (and have little or no value), the company acquires a lazy balance sheet and this increases the risk of poor investments.

I do not believe it to be possible to build a generic model comparing a typical off-market buyback with the “do nothing” alternative. There are two reasons for this view. The first is that one does not know if the company is going to invest the cash successfully or unsuccessfully. The second is that you have to exclude any possibility of the cash ever being distributed- you have to treat the cash as form of capital which can never be returned to the shareholders (i.e. its sole value lies in the future earnings which it is expected to generate). For so long as one retains distribution as a possible future strategy, one must compare the outcome of that distribution strategy with the off-market buyback strategy under consideration.

One dollar of franked undistributed retained earnings held as surplus cash by a company may not be worth one dollar to a high MTR shareholder. The cash when marked for distribution via a fully franked dividend will only be worth $0.7643. An off-market buyback at a 14% discount to market will recover that loss of value. (In the case of the zero MTR shareholder- the one dollar is worth $1.428 but this will be enhanced by participating in an off-market buyback).

Q5.16 *Does the market attribute value to franking credits?*

In the case of private companies the dividend streaming rules prevent any market value from being established. The franking credits only have value to the shareholders if franked dividends are declared to them. They are not marketable.

In the case of listed companies, the 45 and 90 day rules allow streaming of fully franked dividends albeit at considerable risk- one has to sell/ buy the underlying share to trade the franking credit. In addition there will be different tax consequences for different shareholders such that not all shareholders are willing sellers or buyers. Although a value might be able to be discerned from such trading it could not be said that such value would be the appropriate value in other situations. In my view it is quite improbable that the market has ever placed or could ever place a generic value on franking credits- the market would value each situation on a case by case basis.

Where a company has surplus franking credits and is able to generate surplus cash without paying tax on the surplus cash generated, an opportunity may arise to use the surplus franking credits (by way of dividend) thereby releasing trapped franking credits and creating value. If using the credits becomes the preferred strategy, the market might put a value on the credit. The value attributed to the franking credits would only be the net increase in value when compared to the next favoured strategy. Depending upon the shareholder mix, the company's capital structure and other considerations, distribution via dividend may be only marginally superior to a strategy which does not involve using the credits. Thus the presence of alternative strategies may reduce or even nullify any value which the market might otherwise have attributed to franking credits.

Comments on Appendix J

Appendix J contains another method for assessing whether non-participants benefit from off-market buybacks. It has been prepared on a "before and after" basis (i.e. there is no alternative distribution strategy- the alternative strategy is "do nothing").

The "before and after" approach of Appendix J (which may have been called for by the brief) is in my submission inappropriate. Appendix J analyses whether shareholders are better off with the cash remaining in the company or being distributed under an off-market buyback. This is not the issue. The company has already decided that the cash is surplus- the issue is whether off-market buybacks are a better form of distribution than some other form.

The fact that cash has become surplus (i.e. cannot be profitably invested by the company) and is represented by undistributed profits triggers a value shift. The method of distribution crystallizes and definitively quantifies the shift. For example, high MTR shareholders always lose value (under the Appendix J approach) when a fully franked dividend is paid irrespective of the size of the franking credit valuation factor.

Appendix J requires a pre-determined market value to be placed on the franking credits. However the value is itself a function of how the franking credits might be used. Thus one is faced with circularity. (Franking credits have additional value because they might be used in a buyback, a buyback does not distribute that value equitably to high MTR shareholders, and therefore high MTR shareholders lose value).

Should Appendix J form part of the report to the Treasurer I suggest that the buyback data be limited to the 05/06 and 06/07 financial years as the days of discounts of less than 14% to market are a thing of the past. I also suggest that the value given up by participating shareholders be the discount achieved against the tender VWAP rather than the pre-announcement price. The VWAP is struck across the last week of the tender period and represents the value that the participating shareholders are foregoing when they make their election. The announcement price spike is no longer present during the VWAP period. Off-market buybacks which do not contain any dividend component (e.g. ANN) should be excluded from the data.

Verticality

The DP observes that off-market buybacks increase the verticality of the taxation system as they benefit low MTR shareholders. Although that is the case, high MTR shareholders also benefit albeit to a lesser extent.

Yours sincerely,

Edward Griffin

THE BENFITS OF NON-PARTICIPATION IN OFF-MARKET BUYBACKS						
COMPARING AFTER TAX OUTCOMES FOR NON-PARTICIPANTS IN OFF-MARKET BUYBACKS WITH						
THE SAME CASH DISTRIBUTION VIA FULLY FRANKED DIVIDENDS.						
Note						
1. Immediately following the dividend/buyback the company's cash position will be the same.						
2. Accordingly the value of the company will be the same.						
3. Assumes buyback price is VWAP less 14%.						
4. Dividends require more franking credits than buybacks (owing to the capital component) and any value of saved credits by buyback is ignored.						
5. Assumes shareholders are natural persons who are (or will be) entitled to 50% CGT discount.						
6. CGT liability is prospective and only arises on ultimate sale.						
7. All shareholders are worse off receiving a dividend than they would be as non-participants in a buyback (except zero MTR taxpayers- but they participate).						
Marginal Tax rate	**0.465**	**0.415**	**0.315**	**0.165**	**0.000**	
Shares on issue	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	
Value of company ex dividend and ex buyback	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	1,000,000,000	
Value per share ex dividend and pre buyback cancellation	1.00	1.00	1.00	1.00	1.00	
DIVIDEND						
Dividend/share	0.1000	0.1000	0.1000	0.1000	0.1000	
Total fully franked dividend	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000	
Grossed up with franking credit/share	0.1429	0.1429	0.1429	0.1429	0.1429	
Less tax/share	0.0664	0.0593	0.0450	0.0236	0.0000	
Plus franking credit/share	0.0429	0.0429	0.0429	0.0429	0.0429	
Net tax payable/share	0.0236	0.0164	0.0021	-0.0193	-0.0429	
Net after tax/share	0.0764	0.0836	0.0979	0.1193	0.1429	
After tax value of dividend and share	1.0764	1.0836	1.0979	1.1193	1.1429	
OFF-MARKET BUYBACK						
Buyback price @ 14% discount to market	0.8600	0.8600	0.8600	0.8600	0.8600	
Shares bought back per dollar	1.1628	1.1628	1.1628	1.1628	1.1628	

Additional costs of buyback (say)	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	
Buyback $ amount	99,000,000	99,000,000	99,000,000	99,000,000	99,000,000	
Shares bought back and cancelled	115,116,279	115,116,279	115,116,279	115,116,279	115,116,279	
Shares on issue following cancellation	884,883,721	884,883,721	884,883,721	884,883,721	884,883,721	
Value per share after cancellation	1.1301	1.1301	1.1301	1.1301	1.1301	
Capital gain/share	0.1301	0.1301	0.1301	0.1301	0.1301	
Taxable gain using CGT 50% discount	0.0650	0.0650	0.0650	0.0650	0.0650	
CGT prospectively payable	0.0302	0.0270	0.0205	0.0107	0.0000	
After tax value per share	1.0998	1.1031	1.1096	1.1194	1.1301	
COMPARISON						
Additional value created by buyback cf dividend/share	0.0234	0.0195	0.0117	0.0001	-0.0128	
Additional value buyback as % dividend after tax	30.64%	23.37%	12.00%	0.06%	-8.94%	