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The Board of Taxation
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Dear Sirs

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

PricewaterhouseCoopers welcomes the Review of the Taxation Treatment of Off-Market Share Buy Backs with its focus on determining whether the current taxation arrangements for off-market share buy backs remain appropriate.

Our comments below focus on particular issues relevant to the taxation treatment of off-market share buy backs rather than on all of the issues and questions outlined at pages 75-77 of the Board of Taxation's Discussion Paper titled "Review Of The Taxation Treatment Of Share Buy Backs issued in July 2007 ("the Discussion Paper").

All references are to the *Income Tax Assessment Act* 1936 or the *Income Tax Assessment Act* 1997 as relevant and unless otherwise stated.

1. The 45 day rule

One concern raised in the Discussion paper is that investors acquiring shares after the announcement of an off-market buy back but also satisfying the 45 day rule, qualify for franking credits associated with the dividend component of an off-market buy back (refer to paragraph 5.51).

In this regard, it is important to note that the 45 day rule was not designed with off-market share buy backs specifically in mind. Rather, the rule was introduced as one of general application, limiting the benefit of franking to those circumstances where investors have held their investments at sufficient risk for at least a 45 day period.

It is submitted that where shareholders participating in an off-market share buy back have satisfied the 45 day rule there does not seem to be any policy reason for denying the benefit of franking to investors. Indeed, other market transactions exist where similar market behaviour is exhibited by investors, most notably in the case of “special dividend” announcements. As such, imposing some additional or different condition to qualify for franking credits in the context of off-market share buy backs would not seem to be based in principle and would operate to ignore the commercial risks an investor is exposed to in these circumstances (refer for example to paragraphs 5.56).

Accordingly, we do not consider that any change to the existing operation of the 45 day rule is required.

2. Discount to market value – The 14% limitation

Section 177EA is a general anti-avoidance rule that potentially applies to a broad range of schemes for the disposition of shares or an interest in shares, where a franked distribution is paid or payable. This includes off-market share buy backs involving a franked dividend component. Where the section applies the Commissioner will, in effect, debit an appropriate amount to the franking account of the company to compensate the revenue for avoided, wasted, or streamed, franked dividends (refer to paragraphs 22, 117-126 of *Statement Law Administration 2007/9: Share Buy Backs* (“PS LA 2007/”9)).

Relevantly, in PS LA 2007/9 the Commissioner has stated that the discount level is a relevant consideration in the appropriate exercise of his discretion in section 177EA and that the maximum level of discount in a tender process buy back is 14% calculated by reference to the VWAP of the shares for the five days up to and including the closing date of the buy-back. There is no explicit rationale for the 14% limit that has been arrived at by the Commissioner. In this way the limit seems arbitrary and operates to penalise share buy backs at discounts above the 14% discount limit which may be of greater commercial benefit to the company and to non-participating shareholders. Whilst it may be the case that as the level of discount to market value rises the attractiveness of the buy back is limited to tax exempt entities and superannuation funds (refer to paragraph 5.63 of the Discussion Paper) this seems more of a function of the policy design feature of granting preferential tax rates to these entities than an appropriate reason to impose an artificial limitation on a share buy back program directed at increasing the value of the company.

Accordingly, we consider the 14% discount to market value limit currently imposed by the Commissioner should not apply. Rather we consider that the market should establish the appropriate level of discount applicable to an off-market share buy back.

3. Level of Franking Debit

In addition to the arbitrary 14% cap on discount to market value imposed by the ATO, s177EA is also applied to require that a company implementing an off-market share buy back takes a debit to its franking account based on the following formula (as set out in para 126 of PS LA 2007/9):

No. of shares Bought back	x	Franking credit attaching to each	x	Non-residents	x	50%

The Discussion Paper questions whether this application of s177EA should be extended to reflect the "benefit" to shareholders of the effective "streaming" of franking credits as between different classes of Australian resident shareholders. It is submitted that, in addition to imposing a significant additional compliance burden on companies (in terms of the investigation, if possible, of the tax profile of their shareholder base); such a suggestion would be inconsistent with the policy intention of Parliament.

The different taxation treatments listed in the Discussion Paper derive primarily from the Australian Parliament's policy decisions to tax different classes of taxpayer differently. If the off-market share buy back rules were changed to counter the fact that different shareholders are taxed at different rates and, for this reason, "benefit" from franking to different levels, this would distort the free market and frustrate the intent of Parliament to treat taxpayers differentially.

For the same reason, we would actually submit that the debiting of a company's franking account based on the level of non-resident shareholders is inappropriate. Off-market share buy backs are a commercially legitimate method of capital management and there should be no "penalty" imposed by the taxation regime. In addition, participation in off-market share buy backs can be uneconomic for many resident taxpayers (for example, Listed Investment Companies). These taxpayers should not be "penalised" by bearing the cost of the cancelled franking credits.

This "penalty" outcome of s177EA is perhaps most unreasonable in the context of an off-market share buy back by a listed public company. It is also appropriate to suggest that the integrity objective of s177EA is least necessary in the context of listed public companies. We therefore submit that s177EA is amended to exclude from its application off-market share buy backs undertaken by listed public companies.

4. Legislative Safe Harbour Regime

One of the essential elements to be addressed in the context of an off-market share buy back is whether the Commissioner will seek to apply the dividend substitution rule in section 45B. Where the Commissioner determines that this rule should be applied then the payments made to shareholders will be treated as an unfranked dividend. Therefore, almost invariably, listed public companies currently seek a taxation ruling from the Australian Taxation Office that the Commissioner will not make a determination to apply the dividend substitution rule.

In our experience, the most difficult issue to address, is arriving at a dividend/capital split for the distribution to shareholders that does not offend section 45B. Often significant time and expense is exhausted by the taxpayer, taxpayer's advisors and the Commissioner in reaching a conclusion on this particular issue. Notwithstanding the best efforts of the Commissioner, this remains an area where considerable time can elapse before a result is obtained, often at the frustration of taxpayers' commercial intentions.

PS LA 2007/9 is a very welcome advance in this context as it indicates that the Average Capital Per Share methodology is *prima facie* the preferred methodology that should be applied by ATO Officers in the absence of exceptional circumstances when assessing buy back arrangements (refer to paragraphs 12 and 69). However, notwithstanding PS LA 2007/9 it remains necessary for a ruling process to be put to the ATO which may involve lengthy turn around times.

Given the foregoing, we are of the view that legislative safe harbour rules, in a similar vein to those in place for the thin capitalisation regime, should be enacted so that taxpayers do not have to go to the ATO for a ruling on the application of the dividend substitution rule and related integrity rules. These rules would be adopted at the choice of the taxpayer so that where they were not adopted the taxpayer would retain their existing right to seek a ruling in respect of their proposed off-market buy back treatment.

We note that, while PS LA 2007/9 is helpful, it does not bind the Commissioner and is worded permissively, not mandatorily. In our view, unless a well defined series of safe harbours exist; considerable time and energy will continue to be expended on Class Rulings.

In order to remove the need for taxpayers to approach the ATO for a ruling, it is submitted that safe harbour rules should be legislated to cover:

(i) the capital/dividend split methodology (ie. “average capital per share” or “slice” methodologies);

(ii) the s177EA franking debit formula (as set out in the example in para 126 of PS LA 2007/9 or, as suggested above, the removal of any potential application of s177EA in the context of off-market buy backs by listed public companies);

(iii) acceptable level of discount of buy-back proceeds to market price (or, as suggested above, the removal of any limitation or prescription in relation to level of discount to market price);

(iv) a methodology for the determination of market value for CGT purposes (for example, as set out in TD 2004/22 and paras 43-56 of PS LA 2007/9).

5. Distortions between different shareholder return mechanisms

Paragraphs 5.22 to 5.26 of the Discussion Paper refers to the different taxation treatment of various mechanism’s for returning funds to shareholders and some potential mechanism’s for altering the existing framework for the taxation of off-market share buy backs. We are of the view that the existing dividend/capital treatment should be maintained in respect of the taxation treatment of off-market share buy backs.

As noted above, the different taxation treatments listed in the Discussion Paper derive primarily from the Australian Parliament’s policy decisions to tax different classes of taxpayer differently. If the off-market share buy back rules were changed to try to homogenise the tax results for all taxpayers, this would distort the free market and frustrate the intent of Parliament to treat taxpayers differentially.

For completeness, we agree that it would be inappropriate (and impractical) to afford on-market share buy backs the same taxation treatment as applies currently to off-market share buy backs.

However, in relation to an off-market share buy-back by a listed public company, we submit that the taxation treatment should, **at the company’s election**, be either:

(a) the capital/dividend treatment available under the current off-market share buy-back rules; or

(b) wholly capital treatment as applies under the current on-market share buy-back rules.

The Government has accepted that on-market share buy backs should be treated as wholly affairs of capital. This capital management mechanism suites many companies; particularly companies that do not have surplus franking credits (which is common, particularly for those Australian groups with significant profitable offshore operations). However, on-market share buy-backs are subject to limitations under the Corporations Law which significantly reduce the ability of a listed company to utilise this option as a capital management strategy, including:

(i) during any 12 month period, a company can only buy-back up to 10% of the lowest number of shares on issue during the preceding 12 months without shareholder approval (the "10/12 rule"); and

(ii) there are typically "black-out" periods during which a listed company is unable to purchase shares on-market when it is in possession of information which is not available to the market ("insider trading" restrictions).

If a company is unable to achieve its capital management objectives utilising an on-market buy-back program, it should be able to utilise an off-market buy back and, at its election, apply the same taxation treatment for shareholders.

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Should you have any questions in relation to this submission please contact either myself on 8266-7939 or Alastair McLean on 8266-7139

Yours faithfully
PricewaterhouseCoopers

Wayne Plummer

Wayne Plummer
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