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GRSJ:JHW
12 October, 2006

The Chairman
Mr Richard F E Warburton, A O
Board of Taxation
Langton Crescent
PARKES ACT 2600

Dear Mr Warburton,

Off Market Share Buy-Backs

Having played a role over the last several years in drawing attention to unacceptable features of Off Market Buy-Backs which are largely funded by the distribution of tax paid profits as franked dividends I am interested to note the Treasurer's release Number 109 dated 10th October on this subject.

I have been involved in detailed correspondence with the Federal Government at Cabinet level, the Deputy Commissioner of Taxation and the Australian Securities Investment Commission – Deputy Chairman. Reference to my file indicates that one of my submissions – to the Federal Government - was in fact referred to your Board.

In particular I wrote to the Attorney General on March 9 and in case this was not referred to you as is suggested by the received acknowledgement I enclose a copy. This is but one of my submissions and as noted above I have been similarly in touch with the ATO and the ASIC.

The Treasurer's release referred to above notes that "The Board will conduct consultations with stakeholders...." and in this regard I would most certainly welcome the opportunity to be involved.

Would you be kind enough to acknowledge receipt of this communication and let me know the basis upon which I might contribute further towards your deliberations.

Yours sincerely,

G R Sellars-Jones

cc The Hon Philip Ruddock MP
Attorney General
House of Representatives
Parliament House
Canberra ACT 2600

cc The Hon Peter Costello MP
Treasurer
House of Representatives
Parliament House
Canberra ACT 2600

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GRSJ:JHW
9 March 2006

The Hon Philip Ruddock MP
Attorney General
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Mr Ruddock

Off-Market Share Buy-Backs incorporating Fully-Franked Dividends

Having in mind the current Review of the Taxation System, I draw to your attention the circumstances whereby billions of dollars are being diverted / misdirected in blatantly tax-driven schemes.

I refer to corporate "capital management" which involves "off-market" share buy-backs where the consideration is – in major part – funded by the payment of a "franked dividend" component. Regrettably, in spite of a barrage of carefully argued and unanswered criticism over a number of years, this grossly inequitable concept has fallen into common usage.

Representation in detail by myself and others to the Australian Securities & Investments Commission, the Australian Tax Office and the responsible Federal Government Minister has failed – due to an inability or unwillingness to grasp/deal with the unacceptable features.

Let me summarise the relevant aspects:

- The concept of "franked dividends" was introduced in 1987 and was explained in an ATO publication entitled "Imputation of Company Tax".
- Essentially, it relieves the prior circumstance whereby the original $ of company profit was taxed twice – once as company tax and, then when distributed as a dividend, as income in the hands of the recipient shareholder.
- In effect, while the dividend continues to form part of taxable income, a credit is allowed for the tax already paid on the profits out of which the dividend is paid.
- For shareholders on a nil or low tax rate, this can even allow a cash refund.
- It is clear, therefore, that undistributed company profits which have suffered company tax carry something of a "latent asset" in as much as when distributed as dividends, a benefit by way of the franking imputation credit flows to the shareholder.
- It is obvious that shareholders have an equitable interest in the undistributed profits along with the attendant imputation credit.
- The Law dictates that company dividends must come out of profits.

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- The Law also dictates the obvious – Section 254W – that dividends must be paid equitably, i.e., the same amount per share for all shareholders.
- Directors also have a legal responsibility to deal with shareholders equitably and thus not embark on any procedure which benefits certain shareholders to the disadvantage of others.

Let me now summarise what happens with the type of off-market share buy-back which is the subject of this letter.

First, let me note that the objection is not to share buy-backs *per se*, but to those that involve a "dividend" as the major component of the consideration.

Part 2J.1 of the Corporations Act covers Share capital reductions and Share buy-backs. Section 256A, *inter alia*, requires fairness as between shareholders. Section 257B requires equal access plus "offers are to be made to every person who holds ordinary shares to buy back the same percentage of their ordinary shares". The particular Chapter runs for several pages but includes under 257D(4) the extraordinary proviso that "ASIC may exempt a company from the operation of this section". Surely the function of the ASIC is to address and prosecute any breach of the Law rather than have the discretion to offer an exemption.

As opposed to the buy-back where the company offers to buy a number of shares from shareholders – and would therefore be required to comply with the Corporations Law (unless able to rely on the ASIC exemption) – it is structured as an invitation to shareholders to "tender their shares for sale".

Given the taxation advantage implicit in the scheme, the company is able to attract nil or low taxpayers to part with their shares at a significant discount to the price available in the share market. This discount is often of the order of 10% to 14%. Such is the cash tax benefit, entities such as charitable trusts, superannuation funds, etc., rush to buy shares upon the announcement of the scheme in the full knowledge that subsequent sale at a loss will still provide a windfall net cash benefit.

The fact that the company as a result can buy back more shares for a given amount of money is argued as a positive for remaining shareholders.

However – and this is the principal point of the conflicting interpretation of the Law – vast amounts of tax-paid retained profits with the attendant franking credits normally available for equitable distribution to all shareholders as dividends are, while consistently referred to as franked dividends, according to the Australian Securities & Investments Commission "not a dividend for company law purposes".

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We have the absurd situation where the payment has all the essential features of a dividend: it is paid by the company out of retained earnings, it has a franking credit which only a dividend can have, it is taxed as dividend income and is constantly referred to as a "franked dividend" but by decree from the ASIC is not a dividend!

Even if by the wave of some magic wand "dividend" is turned into "capital" or vice versa, the thrust and purpose of the legislation is clear. Retained profits belong to all shareholders and are available for the lawful declaration of dividends. To distribute them otherwise, with their franking credits means that continuing shareholders have lost their entitlement thereto forever. For a company director to plead that they expect to be in a position, notwithstanding, to continue to pay franked dividends in the normal course is not relevant. As I put it in one of my numerous letters published in the Financial Press: it's like an armed felon who has just robbed the bank saying its ok, there's plenty of cash left!

The protagonists argue that: 1, all shareholders are treated equally because all have the same ability to take part, and 2, everyone is a winner because as a consequence of fewer shares on issue after the buy-back is completed, earnings per share go up and presumably the share price, plus ability to pay enhanced dividends.

These arguments are deeply flawed.

In the first place, it is only the very small minority of shareholders which will benefit by participation – those on nil and low tax rates – while those who don't suffer a discriminatory disadvantage. This fundamental inequity thrust upon the majority of shareholders who indirectly fund the benefit to the few can hardly be excused on the basis that "all shareholders have an equal opportunity to participate"!

The EPS argument is invariably presented with the inference that earnings will increase in direct proportion to the decrease in the number of shares on issue. No attempt is made to quantify allowing for the expense of the exercise: executive time, printing and stationery, postage, register fees, cost of advisory services – investment bankers, lawyers, accountants, etc. – nor the negative effect in terms of income foregone from the funds disbursed and/or the interest costs on the funds borrowed to make the payment. In the absence of such detail, this argument falls into the "deceptive and misleading" category.

In any event, hardly can an improper act be justified on the basis of some vague and unquantified consequential alleged benefit for those shareholders whose equitable interest in the company has suffered.

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While the ASIC asserts that the dividend component of the consideration is not a dividend, the ATO insists that it is and therefore taxes it accordingly as income. That the ATO has struggled with the issue is reflected by the fact that the Commissioner in evidence before a Senate Enquiry – Economics Legislation Committee, over four pages on the subject used the words "difficult" or "difficulties" no less than 17 times!

Upon questioning, the ATO has confirmed to me in writing that it is the company which determines and pays the dividend component. This is in direct conflict with any inference from the paying company that the "split" is nothing to do with the company and it is something decided upon by the ATO.

Apart from the huge tax credit so artificially creating, similarly given that the capital component might be only 10% of the consideration, in virtually every instance a totally fictitious (yet usable as a capital gain offset) capital loss is established.

To illustrate further the absurdity of the situation, consider the position in, for example, a deceased estate where a life tenant is entitled to the income from investments and, after the demise of the life tenant, the remaindermen are entitled to the capital. The life tenant lands a windfall of a large dividend and the remaindermen suffer a huge capital loss!

"Oh, what a tangled web we weave ..."

Over several years, I and others, including a number of Australia's leading financial journalists have waged consistent (unanswered) criticism – in my case with the advice and encouragement of the most highly-qualified in the legal profession (including the judiciary at the most senior level), accountants, financial services practitioners, etc.

Further, as one with 47 years experience in the Securities Industry, I have tested the views of private investors. In this context, a survey of typical investors revealed that 97% would prefer an enhanced or special dividend and/or a capital return rather than see excess liquidity paid out in the form of these off-market buy-backs.

I have had lengthy discussion and have exchanged correspondence with the ASIC at the highest level (Deputy Commissioner Jeremy Cooper) and corresponded with the ATO. Also, there should be on file correspondence with Federal Government Ministers, the response indicating a lack of understanding or an unwillingness to look seriously at the issues.

The ASIC did in fact issue guidelines in March 2005 which, apart from making the self-contradictory statement that the "franked dividend" was "not a dividend", failed to address the substance of the objections.

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It has been put to me that ASIC should be issued with a Writ of Mandamus, or a Class Action mounted through the Courts. The preferred view is that if the letter of the Law fails to reflect its intention, then it becomes simply a case of amending the Law so that it does.

We are looking at billions of dollars in tax-driven schemes, demonstrably unfair and on the best advice most probably in breach of the Law. Directors have a legal duty to deal with shareholders equitably. The questions to be asked are: Does a benefit arise? If so, does it fall equitably as between shareholders?

Obviously the answer is that it does not.

At a time when Australia is keen to embrace "World best practice" in terms of investor protection, it is ironic that nowhere else do we find this type of tax-driven manoeuvre. We even find that in the case of our largest company, BHP, in spite of mutual commitment that if either of BHP Billiton Ltd and BHP Billiton Plc pays a dividend, the other must do likewise. In fact "Ltd" is paying a dividend as part (the major part) of the consideration for its off-market buy-back, while "Plc" is embarking on an on-market buy-back.

If the ASIC is not prepared to flex its muscles in protection of the vast majority of shareholders who are clearly disadvantaged, it is up to the Government to take the necessary steps. The intention of the Law is clear. If in fact there is a legal loophole, it needs to be closed.

Could I respectfully suggest that this falls within the scope of the Attorney General.

Given the taxation consequences, it is also the province of the Treasurer and, in fact, given the gravity of the subject and the billions of dollars involved, Members of Cabinet generally, and you will note those to whom I have directed copies of this letter.

Having been deeply immersed in the subject, and having had the benefit of the opinions of some of the keenest, most highly-qualified, legal and financial minds in the land, I am well placed to answer any queries which you might have or otherwise assist further with deliberations.

You are welcome to copies of correspondence between myself and ASIC, ATO and Government Ministers, as well as letters to the media, articles by leading financial journalists and others, as well as a letter from a leading QC to the ATO (subject to his approval).

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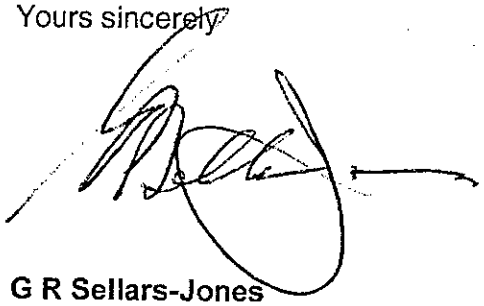
Among recent letters of mine to Jeremy Cooper, Deputy Chairman of the ASIC, is one dated 17 November 2005. It includes the following request – "Would you please regard this communication as a formal complaint to be treated as such by the ASIC". The matters raised continue to be unanswered.

Yours sincerely



G R Sellars-Jones

cc The Hon Peter Costello MP
Treasurer
House of Representatives
Parliament House
Canberra ACT 2600

cc The Hon Malcolm Turnbull MP
Parliamentary Secretary to the Prime Minister
House of Representatives
Parliament House
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