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

email: taxboard@treasury.gov.au

Dear Sirs,

The Taxation Institute of Australia welcomes the opportunity to comment on the discussion paper released by the Board of Taxation entitled "Review of the Taxation Treatment of Off-Market Share Buybacks" (the Discussion Paper).

Overview

We have limited our comments to the matters which are most pertinent from an income tax perspective, rather than seeking to answer all of the questions posed in the Discussion Paper. Accordingly, our submission addresses the following matters:

1. whether franking credit wastage was an underlying design feature of the imputation system;
2. whether the treatment under the current rules of dividing an off-market share buy-back price should be retained;
3. whether there should be a legislative safe harbour in relation to the capital/dividend split;
4. whether the market value consideration rule in subsection 159GZZZQ(2) of the 1936 Act is appropriate;
5. whether the discount at which an off-market share buy-back is undertaken should be limited (i.e. "capped");
6. whether it is appropriate for a taxpayer who receives part of the off-market share buy-back price as a franked dividend to also realise a capital loss;
7. whether the reduction of the capital loss that would otherwise result to a company from participating in an off-market share buy back is appropriate;
8. whether the treatment of on-market and off-market share buy-backs should be aligned;
9. whether off-market share buy-backs by listed and unlisted companies should be treated in the same manner;
10. whether the consideration in respect of an off-market share buy-back should be grossed up for franking credits;
11. whether the ability of a company to frank the dividend component should be denied; and
12. a suggested extension of the CGT small business concession to include proceeds from share buy backs.

We have not specifically dealt with the complexity created by the overlay of the various anti-avoidance provisions (such as the provision of capital benefits rules in s 45B of the *Income Tax Assessment Act 1936* (1936 Act), the 45 day rule in ss 160APHC to 160APHU of the 1936 Act, s 177EA of the 1936 Act, and the anti-streaming rules under s 204-30 of the *Income Tax Assessment Act 1997* (1997 Act)) in off-market share buy-backs but would urge the Board to make recommendations that result in repeal or modifications which ensure that such provisions only apply in exceptional circumstances.

Specific Issues

1. Design feature of the imputation system did not include wastage

At paragraph 2.42 of the Discussion Paper it is stated that one of the design features of the imputation system is wastage of franking credits.

We reject the proposition that wastage of franking credits was a design feature. At the time of the introduction of the imputation system there were level tax rates (except for those on lower rates than companies) and no entitlement to refunds for excess franking credit. In this framework it is unlikely that wastage was considered a design feature.

This issue is important because the concept and assumption of wastage drives a lot of the discussion in the Discussion Paper. It is submitted that franking credit wastage was not and should not be a design feature of the imputation system. The imputation system replaced the classical double tax system. The implications of the wastage concept is a reintroduction of double taxation in circumstances where there has been a change in shareholders. The tax planning issues extending from streaming etc have been, and should be, dealt with by specific integrity measures.

2. Retention of current dividend and capital components

The current rules governing off-market share buy-backs provide that the buyback price may consist of a “capital component” and a “dividend component”, whereby:

- the capital component is equal to the amount debited against the company’s share capital account; and
- the dividend component is equal to the remainder of the buyback price.

It is submitted that the current treatment of off-market share buy-backs be retained as it is consistent with the current treatment of dividends, returns of capital, cancellations and liquidations.

3. Capital/dividend: safe harbour

The legislation governing off-market share buy-backs does not prescribe how a company splits a buy-back price into capital and dividend components. This split depends upon how a company records the buy-back in its accounts. However, in deciding the capital/dividend split, a company needs to have regard to the potential application of a number of integrity provisions: specifically ss 45B and 177EA of the 1936 Act and s 204-30 of the 1997 Act.

The Commissioner has stated in Practice Statement Law Administration PSLA 2007/9 that “there are a number of acceptable methodologies for ascertaining the capital/dividend split, although not all have equal applicability in every case”. The Commissioner advises that tax officers should apply the average capital per share method to determine the dividend/capital split unless companies can demonstrate exceptional circumstances for the use of an alternate methodology such as:

- the slice approach method – ie the capital/dividend split is determined by reference to the ratio of share capital to retained earnings on the company’s most recent balance sheet; and

- the embedded value meothd - ie determination of the capital/dividend split by a demutualised entity by reference to the embedded value/retained earnings ratio.

The Taxation Institute submits that:

- the off-market share buy-back rules should include a legislative “safe harbour” in relation to the capital/dividend split which would preclude the application of the integrity provisions;
- the safe harbour should be structured so that a capital/dividend split will be acceptable if it comes within a specified range;
- the boundaries of the safe-harbour range should be set by reference to what the capital/dividend split would be under the average capital per share method and what it would be under the slice approach method; and
- the legislation should provide for the safe harbour to apply unless companies can demonstrate exceptional circumstances for the use of an alternate methodology.

A legislative safe harbour would:

- improve the efficiency of undertaking an off-market share buy-back;
- result in companies being treated equitably vis-a-vis one another; and
- retain the flexibility to deal with situations where a capital/split within the safe harbour range would be inappropriate.

In relation to efficiency, the provision of a safe harbour would provide a means of obtaining certainty as to what the outcomes of an off-market share buy back would be, without the need to seek private and class rulings. The submitted safe harbour range would encompass the range of capital/dividend splits that the Commissioner indicated in PS LA 2007/9 would generally be accepted. It would therefore be expected that the majority of off-market share buy-backs would fall within the safe harbour.

4. The market value consideration rule

Subsection 159GZZZQ(2) of the 1936 Act provides that if the buyback price is less than the amount that would have been the market price had the buy-back not occurred and never have been proposed to occur, then for the purposes of determining the capital component the consideration is taken to be what the market value would have been in those circumstances. The effect of this rule is that the amount of any gain or loss that might otherwise arise to the shareholder from the buyback of a share is respectively increased or reduced by an amount (the difference between the buyback price and the market price) that is never actually received.

It is submitted that this rule should only apply where an off-market share buy back is not conducted at arm’s length for the following reasons:

- the assessment of a notional amount where parties are dealing at arm’s length is inequitable; and
- limiting the application of the rule to non-arm’s length dealings would bring it into alignment with the capital gains tax (CGT) provisions contained in Parts 3-3 and 3-5 of the 1997 Act. Pursuant to para 116-30(2)(b)(i) the capital proceeds from a CGT event (other than C2) will be replaced with the market value of the CGT asset only where the parties to the CGT event did not deal with each other at arm’s length.

5. Discount to market value

Off-market share buybacks undertaken by listed companies are commonly undertaken at a discount to the price at which the companies’ shares are being traded. The current off-market share buy-back rules are not ostensibly concerned with whether such a buy-back is conducted at a discount, save for the market value rule in s 159GZZZQ(2) of the 1936 Act (the application of which is limited to off-market share buy-backs that are not conducted at arm's length).

However, the Commissioner in PSLA 2007/9 states that where an off-market share buy-back undertaken by a listed company is conducted at a discount in excess of 14%, it will be considered to constitute a streaming of franking credits to low taxed or tax exempt resident shareholders and in these circumstances the anti-streaming rules in s 177EA of the 1936 Act should apply. The Commissioner has not disclosed how he determined that 14% was the maximum allowable discount.

The decision to participate in an off-market share buy-back depends not only on the discount but also on the capital/dividend split, and the extent to which the dividend component is franked. The discount that is appropriate for one combination of capital/dividend split and franking level is not necessarily appropriate for another such combination. These considerations are not driven by tax avoidance. In fact, under the new marginal tax rates (48.5%) there is very little difference in the tax outcome in selling shares or participating in a buy back.

Thus, it is submitted that where an off-market share buy-back is conducted at arm's length, the discount in respect of a buy-back price should be set by free market forces and not be capped by either the off-market share buy-back rules or by the Commissioner's practice. The reasons for removing the cap are that:

- the discount is the means by which shareholders who do not participate in an off-market share buy-back are compensated. This is acknowledged at paragraph 5.37 of the Discussion Paper. A cap on the discount is potentially detrimental to the non-participating shareholders as it could limit the increase in value of their shares arising from an off-market share buy-back;
- to the extent to which off-market share buy-backs facilitate the efficient allocation of capital, a cap on the discount could potentially distort and therefore impede this;
- if the Government, in certain circumstances, wish to prevent low-tax or tax-exempt entities obtaining the benefits of franking credits from participating in an off-market share buy-back, we consider that it would be preferable for those circumstances to be clearly articulated and specifically addressed in the legislation.

6. Realising a capital loss from participating in an off-market share buy-back

The current rules governing off-market share buy-backs provide that a capital loss results where the capital component of an off-market share buy-back price is less than the cost base of the shares bought back. The Discussion Paper questions the appropriateness of realising a capital loss from participating in an off-market share buy-back where the dividend component is franked.

The Taxation Institute submits that the realisation of a capital loss should be retained. The loss is required to avoid double taxation (ie, being taxed on both the dividend component and a capital gain), which is acknowledged at paragraphs 3.50 and 5.72 of the Discussion Paper. In considering the appropriateness of the capital loss it is also necessary to take account of the fact that the off-market share buy-back price may be at a discount to the market value. The discount counter-balances the franking credits provided to the participants in an off-market share buy-back.

7. Reduction of capital loss realised by a company in an off-market share buy back

Where a company participates in an off-market share-buy and the capital component of the buy-back price is less than its cost base, s 159GZZZQ(8) of the 1936 Act has the effect of reducing the capital loss that would otherwise result, to the extent the dividend component of the buy-back price is franked. The Discussion Paper does not articulate the basis for the loss reduction, nor does it evaluate whether it is appropriate.

- It is submitted that the loss reduction is inequitable and that s 159GZZZQ(8) should be repealed. The basis of this submission is that the loss reduction results in double taxation. That the loss is required to avoid such double taxation is acknowledged at paragraphs 3.50 and 5.72 of the Discussion Paper.

8. Treatment of on market share buy-backs

The provisions dealing with on-market share buy-backs provide that:

- no part of the buy-back price is treated as a dividend (irrespective of whether or not a company may debit its profits in relation to the buy-back);
- the buy-back price is treated as consideration for the sale of the shares bought-back; and
- a franking debit may result to the company if all or part of the buy-back price is debited against its profits.

In contrast, an off-market buy-back price may comprise a dividend and/or a capital component.

The Taxation Institute submits that the treatment of on-market and off-market share buy-backs should not be aligned. The current treatment of on-market share buy-backs should be retained for the following reasons:

- when a shareholder sells shares on-market they generally do not know the identity of the buyer. If on-market share buy-backs were treated in the same way as off-market share buy-backs, shareholders selling shares on-market would not have certainty as to the consequences of such sales; and
- if on-market share buy-backs were treated in the same way as off-market share buy-backs the tax consequences could be inequitable in that different tax consequences could result for different shareholders, notwithstanding that they all disposed of their shares on-market.

9. Off-market share buy-backs conducted by listed and unlisted companies

The current rules governing off-market share buy-backs apply equally to listed and unlisted companies. It is submitted that this alignment of treatment should be retained.

However, the valuation of shares in an unlisted company that undertakes an off-market share buy-back is often disputed by the ATO. To reduce the occurrence of such disputes it is suggested that the ATO issue clear guidelines as to how shares in unlisted companies should be valued. We would be happy to consult in the development of such guidelines.

10. Grossing-up the consideration for franking credits

The current rules governing off-market share buy-backs do not provide for the consideration in respect of the buy-back to be grossed-up for the franking credits in relation to the dividend component of the buy-back price. The Discussion Paper questions whether the market value of the shares, with respect to the gain or loss arising from an off-market share buy-back is calculated (effectively the consideration under the current rules), should include the value of such franking credits.

It is submitted that the consideration in respect of an off-market share buy-back should not be grossed-up for franking credits. Not grossing-up the consideration for franking credits is consistent with the policy objective underlying the imputation system: that distributed profits of a company are effectively subject to tax at the shareholder's applicable rate of tax. In contrast, grossing-up the consideration for franking credits would be inconsistent with that policy objective and in this regard it could be considered to result in double taxation. These outcomes are illustrated in the example below.

Example

Assume that:

- a company undertakes an off-market share buy-back in respect of which the dividend component provided to a participating shareholder is $70.00, which is 100% franked and that the capital component is $50.00; and
- the shareholder's applicable rate of tax is 30% and its cost base is $50.00 .

If the consideration is not grossed-up for the value of franking credits, the distributed profits of the company would be subjected to tax at the rate of 30%. However, if the consideration is so grossed-up, the distributed profits of the company would be subjected to tax at the effective rate of 39%.

	Consideration not-gross-up $	***Consideration grossed-up $***
Dividend component	70.00	70.00
Franking credit gross-up	30.00	30.00
CGT gain	-	30.00
Taxable income	100.00	130.00
Tax @ 30%	30.00	39.00
Franking tax offset	(30.00)	(30.00)
Tax payable by shareholder	-	9.00
Tax paid at company and shareholder levels	30.00	39.00
CGT calculation		
Consideration	50.00	80.00
Cost base	(50.00)	(50.00)
CGT gain	-	30.00

11. The ability to frank the dividend component

The current rules governing off-market share buy-backs provide that the dividend component of the buy-back price may be franked. The Discussion Paper questions whether it is appropriate for the dividend component to be franked.

The Taxation Institute submits that the ability of a company to frank the dividend component should be retained. The franking of the dividend component is consistent with the policy objective underlying the imputation system: that distributed profits of a company are effectively subject to tax at the shareholder's applicable rate of tax. Denial of the ability to frank the dividend component would be contrary to this policy objective and in this regard it could be considered to result in double taxation. These outcomes are illustrated in the example below.

Example

Assume that:

- a company undertakes an off-market share buy-back in respect of which the dividend component provided to a participating shareholder is $70.00, which is 100% franked and that the capital component is $50.00; and
- that shareholder's applicable rate of tax is 30% and its cost base is $50.00 .

If the dividend component is 100% franked, the distributed profits of the company would be subjected to tax at the rate of 30%. However, if the dividend component was not franked and remained assessable, the distributed profits of the company would be subjected to tax at the effective tax rate of 51%

	Dividend component franked $	***Dividend component not franked***
Dividend component	70.00	70.00
Franking credit gross-up	30.00	-
CGT gain	-	-
Taxable income	100.00	70.00
Tax @ 30%	30.00	21.00
Franking tax offset	(30.00)	-
Tax payable by shareholder	-	21.00
Tax paid at company and shareholder levels	30.00	51.00
CGT calculation		
Consideration	50.00	50.00
Cost base	(50.00)	(50.00)
CGT gain	-	-

12. Interaction with CGT small business concession

The current system provides an imbalance for an exiting shareholder entitled to the small business CGT concession when considering either selling shares or participating in a buyback. It is submitted that it would be appropriate to allow exiting shareholders the opportunity to pay some or all the proceeds received on a share buyback into a complying superannuation fund. This would be an appropriate mechanism for accessing the benefits of the small business CGT concessions in for shareholders who have funded the expansion of their business by foregoing dividends.

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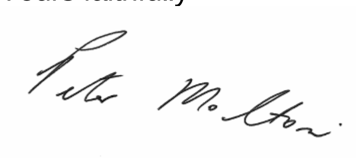
If you would like to meet with the representatives from the Taxation Institute or require any further information or assistance in respect of our submission, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully



Peter Moltoni
President