The Institute of Chartered Accountants in Australia

Submission on the Review of the Taxation Treatment of Off-Market Share Buybacks

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Submission on the Review of the Taxation Treatment of Off-Market Share Buybacks

Executive Summary

1. Introduction

The Institute is of the opinion that the taxation rules for off-market share buybacks are appropriate in most respects. However, our submission highlights a number of areas and issues for consideration by the Board.

Rather than seek to address all of the questions posed in the Discussion Paper, our comments are focused on the taxation aspects of share buybacks.

2. Use of franking credits

The Institute is of the view that:

(a) while there is clear parliamentary policy of having dividend imputation wastage in relation to dividends paid to non-residents, there is no such policy currently operative in relation to dividends paid to Australian residents;

(b) the operation of the dividend imputation system should to the greatest possible extent treat cash dividends and deemed dividends in a similar manner so as to not create new distortions and complexity in the Australian tax system;

(c) if the Australian Government considers that the refundable tax offsets attributable to franked dividends paid to tax exempt bodies should no longer be available, that decision should be reached very carefully having regard to consistency with the policy which applied when this mechanism was introduced. That consideration should also take into account the impact on the investment of funds of the relevant bodies entitled to refundable tax offsets of franking benefits;

(d) no case has been made of a fundamental revenue cost or disadvantage arising from off-market share buybacks which warrants drastic attention;

(e) to the extent that there is trading in the ordinary shares of companies which make announcements of off-market share buybacks, which occurs after the announcement, the Institute recognises that the Government might consider that such market practices are inconsistent with long-term stable share ownership. However, the Institute does not see any fundamental tax cost or disadvantage which flows from this practice and the economic implications and additional liquidity created in the market by such behaviour should also be considered.

3. Distortions between different mechanisms

(a) The Institute submits that the proposals to include franking credits in the calculation of market value or to deny companies the ability to frank the dividend component would result in double taxation consequences so neither of these proposals is supported.

4. Implications of the 45-day rule

(a) The Institute submits that there is no need to change the 45-day rule as it applies to off-market buyback transactions as the rule provides a robust and generally accepted approach to be able to qualify for franking credit benefits. No distinction should be made between off-market buyback transactions and other dividend-based transactions (such as a special dividend).

(b) On a related matter, the Institute believes that there is an urgent need for the Treasury to conclude its review on whether 15 days is an appropriate period in which to hold the shares to qualify for a franking credit benefit (as recommended by the RBT).

(c) We are also of the view that the operation of the LIFO rule in regard to the purchase of additional shares needs to be addressed.

5. Resident to resident streaming

(a) The Institute notes the clear policy of government on non-wastage in relation to imputation benefits on dividends to residents (as opposed to non-residents). Any government policy change would need to be carefully thought through in the light of full policy considerations.

(b) The Institute is of the view that the dividend streaming rules do not apply to transactions involving two different shareholders where both shareholders or types of shareholders are entitled to imputation benefits.

(c) It is by no means clear that an off-market share buyback involving existing shareholders would attract section 177EA.

(d) The Institute recommends that any regulatory power by the Commissioner of Taxation, leading to adjustment of the franking account outcomes in relation to off-market share buybacks, should be excised from section 177EA and relocated into the simplified imputation system rules as use of the general anti-avoidance rule in this context is undesirable.

6. Discount to market value

(a) The Institute does not agree with the arbitrary limit of 14% placed on the discount allowed to be given as a tender price in an off-market buyback and submits that the level of discount should not be restricted at all but determined by a free market.

(b) We reiterate our view that the policy behind the anti-streaming and franking credit trafficking provisions is targeting streaming to residents of dividends which would otherwise pass to non-residents so it is not appropriate for the anti-avoidance provisions to be used as a cap on the discount to prevent resident to resident streaming.

7. Capital dividend split

(a) The Institute recommends that a "safe harbour" capital/dividend split be provided for in the legislation to ensure a reduction in compliance costs and to provide greater certainty.

(b) Any legislative approach should be coupled with an allowance for an alternative approach to be accepted by the Commissioner – whereby the legislation could suggest conditions that would be required to be satisfied where an alternative approach is taken. (See section 9 on ATO administration).

8. Capital losses

(a) In general, the Institute would not support a change to remove the ability to claim capital losses under an off-market share buyback as the availability of a capital loss helps reduce the instance of double taxation. We note however, that while capital losses have benefit to taxpayers, it is generally something less than 100% of the tax loss

(b) The Institute submits that the treatment of capital losses for companies under subsection 159GZZZQ(8) of the ITAA 1936 needs to be addressed in terms of whether this treatment is acceptable from 1 July 2002.

9. ATO Administration

(a) The Institute submits that streamlining ATO administration and compliance aspects of off-market share buybacks would achieve significant cost savings. The Institute considers that although promoting transparency, the practice statement, PS LA 2007/9, does not provide the level of certainty required to remove the need of companies to obtain class rulings.

(b) The Institute considers that there are, in broad terms, two approaches that can be pursued to provide certainty – being legislative change (such as safe harbours) or binding administrative rulings. The Institute submits that the preferred approach is legislative change as it is more absolute and, if properly drafted, will provide the required level of certainty. To maintain flexibility, the legislative change should be in the form of an elective concessionary treatment.

(c) The concessionary treatment could be in the nature of safe harbours. Items that may be covered are in relation to market value of the share bought back, capital and profit split and franking debit. The legislation should also specifically allow as an alternative to safe harbours the ability for taxpayers to approach the Commissioner for a decision.

(d) The Institute recommends that appropriate consultation take place to determine whether one or two sets of safe harbours are required (one for listed and one for unlisted companies).

10. Share buybacks and unlisted companies

For unlisted companies, in general:

(a) the Institute sees little wrong with the drafting of the current tax rules for share buybacks in so far as they apply to unlisted companies (as reflected in the Board's comments at para 4.25). However our members report compliance difficulties in dealing with the ATO on private ruling requests relating not just to these rules, but also other provisions relevant to the return of capital or distributions to shareholders;

(b) the share buyback tax rules facilitate commercial arrangements which enable unlisted companies to restructure;

(c) the Institute does not believe that separate share buyback tax rules should apply to widely held and closely held unlisted companies, but acknowledges that this delineation raises broader tax policy questions which may be worthy of a separate consultation exercise;

(d) clear valuation guidelines and documentation arrangements would be of use to reduce disputes over valuation of shares in unlisted companies

11. Share Buybacks and Employee Share Plans

(a) The interaction of the current off market share buyback tax rules with the provisions for taxing employee share plans can produce adverse outcomes for employees that are neither fair nor appropriate.

(b) Off-market share buy backs could be used to a far greater extent to facilitate the operation of share plans, by both listed and unlisted companies, if the tax rules did not create adverse consequences.

(c) The Institute recommends that a carve-out from the share buyback tax rules be provided for all employee share plan transactions. Alternatively, a carve-out should apply for employee share plan buybacks that are not part of a broader buyback arrangement participated in by all shareholders.

1. Introduction

The Institute of Chartered Accountants in Australia (the **Institute**) 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**).

The Institute is Australia's premier accounting body, which represents over 44,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy services or in diverse roles in business, commerce, academia or government.

Rather than seek to address all of the questions posed in the Discussion Paper, our comments are focused on the taxation aspects of share buybacks. Matters relating to capital management strategies and market implications (e.g. reasons for growth in off-market share buybacks, alternatives, impact on earnings per share, etc) are best answered by other stakeholders (such as companies that have undertaken share buybacks and capital management advisors).

All references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

2. Use of franking credits

This section covers the underlying issues of the use of franking credits by Australian companies and their shareholders. This responds also to the comments in the Discussion Paper under the heading of "Optimal use of franking credits" where the Board notes that off- market share buybacks:

- are an efficient mechanism for making optimal use of franking credits
- "enable companies to distribute franking credits to those shareholders who are best able to use them and avoid them being wasted on shareholders who cannot use them" and
- by their efficiency "are likely to do so at a cost to the taxation revenue."

The Discussion Paper states that:

> "5.17 In addition, the general policy underlying the imputation system is that over time franking credits should be spread more or less evenly across shareholders in proportion to their shareholdings. Consequently, there will be some shareholders who cannot use, or cannot fully use, the imputation benefits but will nevertheless receive franked distributions. **This results in the wastage of those benefits, which is a design feature of the imputation system.** This is the benchmark used in assessing the tax expenditure associated with off-market share buybacks. As noted in Chapter 3, there are a number of provisions in the tax law designed to ensure that this objective is not circumvented. In practice, the Commissioner generally exercises his discretion under section 177EA to debit the franking account of the company where the streaming of franking credits from non-resident to resident shareholders can be identified. This reduces the benefits to the companies and the non-participating shareholders of the off-market share buyback. However, as noted below, the extent to which it does so depends on the value attached to the franking balance of the company." (emphasis added)

The Institute would like to raise some issues in relation to the above statement that the wastage of those imputation benefits "is a design feature of the imputation system."

This statement is somewhat misleading and the Institute would not wish it to lead to incorrect policy analysis. Therefore the Institute wishes to highlight the following key policy drivers for consideration by the Board and by the government, in this regard:

- It is clear that from the early days of the imputation system that the wastage of franking credits is intended in relation to dividends which would otherwise flow to non–residents of Australia. For non–residents of Australia the receipt of a franked dividend entitles them to not pay dividend withholding tax on that dividend. The anti streaming rules introduced into the imputation system were designed to confirm the inability of Australian companies to stream franked dividends as between resident and non-resident shareholders.

- However in relation to franked dividends paid to Australian residents, it is not correct to state that in 2007 there is a policy driver relating to wastage of franking credits.

  This is readily apparent from the fact that the government introduced in 2000 measures for the provision of refundable franking credits for Australian shareholders, as an express policy and legislative measure following formal recommendations of the Ralph Review of Business Taxation (RBT).

  The refundable franking credit measures are contained in section 67-25 (1) to (1E). It is absolutely clear that these tax offsets are subject to the refundable tax offsets rules, and this treatment applies to:
  - individuals
  - beneficiaries of trusts
  - trustees assessed on a resident beneficiary's share of net income
  - complying superannuation funds and ADFs
  - life insurance companies, friendly societies, PSTs entitled to franking offsets
  - taxpayers entitled to venture capital offsets
  - tax–exempt registered charities and gift deductible organisations.

  We emphasize that parliament made these decisions following a review of the underlying policy of dividend imputation and recommendations from the RBT.

  The Institute notes that the RBT recommendation 11.7 was for the fully refundable franking credits to be provided only to, broadly, individuals, superannuation funds and registered charities in certain circumstances. However the parliament of Australia, guided by policy thinking of the Federal Treasury, made a decision to extend the refundable tax offset rules somewhat more broadly. The RBT clearly recommended that off-market share buy-backs should have different treatment to on-market share buy-backs (Recommendations 12.18 and 12.20)

We submit that it would be incorrect and misleading to state that in 2007, there is government or Treasury policy that there should be wastage of franking credits in relation to distributions among Australian resident shareholders (as distinct from the wastage that is clearly specified in relation to non-resident shareholders).

The Institute accepts that the government might determine at some stage that there should be some limitation on the availability of franking credits in respect of tax exempt shareholders. However, this would require new, formal, policy decisions to be undertaken by the federal government.

Any such policy change would require an alteration to the policy that is clearly evident through the introduction of the refundable tax offsets rules and would need to be properly considered and costed as to its impact on tax exempt bodies.

2.1 What should be the policy in relation to franking benefits to Australian shareholders?

The Institute considers that, if a part of the proceeds of an off-market share buyback is to be treated as a dividend under Division 16K of the *Income Tax Assessment Act 1936* (ITAA 1936), then a primary policy driver from the perspective of equity and efficiency should be consistent treatment of such deemed dividends under Division 16K and cash dividends. This means that, if a cash dividend gives rise to refundable tax offsets on account of franking benefits, then the deemed dividend should also give rise to refundable tax offsets.

So the first principle should be an alignment of the treatment of deemed dividends such as those under Division 16K and cash dividends.

The second issue for clear policy consideration is whether or not to continue the refundable tax offset treatment in relation to tax exempt organisations. This has been discussed above.

The third policy issue is to recognise that there will always be differences between different Australian taxpayers in relation to their tax profiles, and there is no policy basis to differentiate between resident Australian investors, and certainly not between taxable Australian resident investors. Since the inception of the dividend imputation system there have been different tax rates and issues for individuals, superannuation funds and companies. This means that different classes of investor will have different economic outcomes from a franked dividend. The difference in tax outcomes for shareholders from a franked dividend has been a feature of dividend imputation since its inception, so a difference in the tax outcomes for shareholders participating in off-market share buybacks is consistent with the remainder of the dividend imputation system.

2.2 Off-market share buybacks generate economic benefits for companies and are equitable for all

The Institute notes that off-market share buybacks, using the recent practice of companies seeking tenders from shareholders as to the level of discount which they will accept in relation to an off-market share buyback, represent an efficient use of franking credits which is:

- to the benefit of continuing shareholders in the company, achieving equity among participating and non-participating investors,
- to the benefit of participating shareholders tendering for off-market share buybacks,
- to the benefit of a strong Australian corporate sector, and
- to the benefit of the Australian economy.

In particular the practice of tendered off-market share buybacks means that shareholders are invited to consider the franked nature of the deemed dividend component of the off-market share buyback, and to propose the price at which they would accept the repurchase of their shares in the company. The participating shareholders tender the discount to the relevant quoted price as being an acceptable price for the repurchase of their shares.

The mechanism of the tender, the discount and the repurchase means that the benefits of the franking attributable to the dividend, in the large part, flow back to the company making the off-market share buyback. This is a positive development in the view of the Institute. The flow back of value to the company, pursuant to the tender process, has the following effects:

(A) The franking benefits attributable to the deemed dividend are enjoyed by the shareholder, in precisely the same circumstances as would arise if a cash dividend had been declared. We emphasize that if a company, instead of making an off-market share buyback, had paid a cash dividend, then the same consequences would arise for the revenue, and in respect of non-residents.

(B) From the viewpoint of the company, the franked dividend component of the off-market share buyback results in a benefit accruing to the company in a permanent form, as compared with the position of a cash special dividend, the benefit being the capacity to make a discounted buyback of its shares on issue . The company is able to use this enhanced value to strengthen its balance sheet, to improve its profit earning capacity, and therefore to generate increased taxable income which will be subject to the company tax system.

(C) The continuing shareholders benefit also. It is quite clear that continuing shareholders in the companies which undertake the off-market share buybacks are advantaged in an appropriate manner. This arises because the tender process means that the franked dividend component of the off-market share buyback leads to compensation by the participating shareholders back to the company. To the extent that the company benefits from that compensation implicit in the tender process, the greater strength of the company is to the benefit of the continuing shareholders. Every shareholder which does not participate in the off-market share buyback is advantaged because of the fact that the company is able to reduce its capital, thus concentrating the wealth and strength of the company in the hands of a smaller group of shareholders whose interests are therefore enhanced.

This commercial understanding, as communicated by company boards and communicated to the Australian corporate regulators confirms that there is no abusive behaviour in this regard. The continuing shareholders benefit from the off-market share buyback process in an equitable manner. Indeed the benefit to existing shareholders was noted by ASIC in 2005[1].

(D) To the extent that there are non-resident shareholders on the share register of the relevant company, a franking debit is made to the company's franking account, thus ensuring that the long-legislated wastage of franking in relation to non-resident entitlements is maintained.

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[1] ASIC media release of 3 March 2005, 05-44 - ASIC'S position on off-market share buy-backs incorporating fully franked dividends. http://www.asic.gov.au/asic/asic.nsf/byheadline/05-44+ASIC'S+position+on+off-market+share+buy-backs+incorporating+fully+franked+dividends?openDocument

2.3 What are the precise costs to the revenue?

There are comments in the Board's Discussion Paper about estimates of a preliminary nature, made by Federal Treasury, of the perceived costs to the revenue of off-market share buybacks. The Institute shares the concerns of the Board about the transparency and completeness of these estimates referred at paragraph 4.29ff. of the Discussion Paper.

This discussion refers to the estimates of "tax expenditure" under the Treasury Tax Expenditures statements which seek to identify the difference between the tax actually payable and the tax that would have been payable if the franking credits have been evenly distributed amongst all shareholders.

However, as the Board itself identifies, these estimates are very general and questionable in their accuracy (para. 4.31). The Board's Discussion Paper itself notes that the estimates do not take into account:

- behavioural changes in this area
- capital losses that participating shareholders generally incur
- debits to the franking account of the company under the anti-avoidance provisions
- the impact of the reduced cost base for shareholders arising from the off-market share buyback on their future capital gains tax payable.

The Institute is of the view that there is no case made that off-market share buybacks represent a significant revenue cost to the Australian revenue, having regard to the concerns rightly expressed in the Discussion Paper at para. 4.29ff and in the absence of consideration of the overall benefits to Australian economic efficiency.

Further, even if there was some element of revenue cost, the Institute questions whether that represents a disadvantage to the Australian revenue when compared to the significant increase in the efficiency of structuring of Australian companies which is occasioned by off-market share buybacks.

2.4 Post announcement trading in relevant companies

The Institute recognises, as noted by the Board of Taxation, that market practice has emerged in this area that, after a company announces its intention to undertake an off-market share buyback, the ASX listing rules require that shareholders be granted a period of time to trade their shares with the entitlement.

This ASX listing requirement means that, after an off-market share buyback is announced, there is an opportunity for new shareholders be added to the relevant company's share register or for existing shareholders to increase their investment to benefit from the tendering process in relation to the off-market share buyback. The Institute recognises that such shareholders can be seen on one view as being short term in their orientation, and it might be suggested that they should not benefit from the tax features of the off-market share buybacks.

However the Institute also notes some factors which need to be recognised before policy decisions are undertaken:

(A) The incoming shareholders, which presumably will be more favourably disposed to the off-market share buyback, add liquidity and demand to the off-market share buyback to be undertaken by the company. The Board should consider whether any restrictions on post announcement trading would adversely affect the continued success of off-market share buybacks.

(B) The Institute notes that the shareholders who enter the share register and participate in the tender process in relation to the off-market share buyback, in turn offer to sell their shares to the company at a lesser price than the prevailing market price. In other words, the entry of these post announcement investors ultimately enhances the success of the off-market share buyback and sees value transfer occurring back to the company. Thus the Institute would question whether restrictions on post announcement trading would ultimately lead to any different tax, revenue or economic outcomes to those which operate under the current rules – with the potential exempt exception of reducing the volume of shareholders willing to tender their shares into an off-market share buyback.

(C) The ATO has various approaches set out in the practice statement PS LA 2007/9 to limit the ability of shareholders to engage in post announcement share investment prior to the operative date for the buyback. The Institute comments on the 45-day rule in section 4 below. If it were to be determined by the Board that there needed to be regulation in this area then any action should be by way of statutory clarification of the rules rather than leaving these issues to be resolved in administrative practices managed by the ATO.

Use of franking credits - summary

The Institute is of the view that:

(a) while there is clear parliamentary policy of having dividend imputation wastage in relation to dividends paid to non-residents, there is no such policy currently operative in relation to dividends paid to Australian residents;

(b) the operation of the dividend imputation system should to the greatest possible extent treat cash dividends and deemed dividends in a similar manner so as to not create new distortions and complexity in the Australian tax system;

(c) if the government considers that the refundable tax offsets attributable to franked dividends paid to tax exempt bodies should no longer be available, that decision should be reached very carefully having regard to consistency with the policy which applied when this mechanism was introduced. That consideration should also take into account the impact on the investment of funds of the relevant bodies entitled to refundable tax offsets of franking benefits;

(d) no case has been made of a fundamental revenue cost or disadvantage arising from off-market share buybacks which warrants drastic attention;

(e) to the extent that there is trading in the ordinary shares of companies which make announcements of off-market share buybacks, which occurs after the announcement, the Institute recognises that the Government might consider that such market practices are inconsistent with long-term stable share ownership. However, the Institute does not see any fundamental tax cost or disadvantage which flows from this practice and the economic implications and additional liquidity created in the market by such behaviour should also be considered.

3. Distortions between different mechanisms

While the proposals under paragraph 5.23 (to include franking credits in the calculation of market value) and 5.24 (to deny companies the ability to frank the dividend component) would appear to achieve greater neutrality between on-market and off-market share buybacks for listed companies, from a policy perspective we believe that these proposals would result in double taxation consequences. The proposals would effectively result in an increase in the overall tax payable under an off-market buyback, such that additional tax would be collected from each taxpayer as compared to their ordinary marginal tax rate.

While the proposal may make an off-market buyback less attractive (and therefore would reduce the attractiveness of such arrangements), we do not believe that increasing instances of double taxation is an appropriate mechanism to achieve this result.

It is noted that the main concern identified in the Discussion Paper is the ability to stream benefits to lower tax shareholders as opposed to higher tax shareholders. To this end, the capital/dividend split, the discount rules and the anti-avoidance rules are all aimed at restricting the level of benefits provided to lower tax shareholders, and accordingly these mechanisms should be considered sufficient.

Distortions between different mechanisms – summary

(a) The Institute submits that the proposals to include franking credits in the calculation of market value or to deny companies the ability to frank the dividend component would result in double taxation consequences so neither of these proposals is supported.

4. Implications of the 45-day rule

The Institute sees no particular mischief with investors being able to buy shares following the announcement of a buyback and, subject to satisfying the 45-day rule, being characterised as a "qualified person" entitled to franking credits in relation to dividends arising. As such, the Institute sees no reason to amend the application of the 45-day rule in the circumstances.

In other words, the fact that a particular shareholder is considered sufficiently at risk and holds its shares for the prescribed period (45 days) then they should be entitled to the underlying franking credits and no distinction should be made between an off-market share buyback transaction and other transactions (such as a special dividend) to which those rules also apply.

The RBT examined the application of the 45-day rule. In fact, that review recommended a shorter ownership period be adopted since the underlying rationale for the adoption of a 45 day period (the US position in relation to its analogue of the intercorporate dividend rebate) was not wholly appropriate in the circumstances and other countries have operated with shorter ownership periods. The recommendation from the RBT was that a period of 15 days be adopted since such a period more appropriately reflects the time frame of commercial dealings transacted in the modern capital markets. The Ralph Review concluded that tax induced transactions generally had a shorter time frame than 15 days and therefore, investors would be appropriately denied franking credit benefits in these circumstances. In fact in November 1999, the Treasurer issued a Press Release announcing that measures will be introduced to reduce the 45 day holding period and further analysis and consultation would be held to determine whether a 15 day holding period would be sufficient to deter franking credit trading. The result of that review is still outstanding.

Putting to one side the question of whether 45 days remains an appropriate holding period but noting that a shorter period is accepted as being appropriate from a policy perspective, the following points should be noted:

- The Discussion Paper cites evidence which supports the view that there may be distortions to prices and market activity caused by "tax induced" trading around the announcement of an off market buyback. In the Institute's view, if it is accepted that 45 days remain the appropriate holding period and that the particular investor is "effectively at risk", then as a matter of course, they should be entitled to the underlying franking credit attached to any buyback proceeds. In other words, it is the period prescribed for holding which is the deterrent to franking credit trading and not an approach which distinguishes between transactions according to their legal form.

- The Discussion Paper acknowledges that similar issues arise with special dividends in-so-far as taxpayers can buy shares in sufficient time to take advantage of franking credits attached to that dividend. In a special dividend situation, all shareholders will receive the dividend while in an equal access buyback offer, all shareholders have the opportunity to participate. In the Institute's view, there is no good policy reason why a distinction should be drawn between a special dividend and a buyback transaction.

- The Discussion Paper notes anecdotal evidence that there is anticipatory trading prior to the announcement of the buyback in certain cases (for example, because a buyback is foreshadowed at an Annual General Meeting). The Institute believes that a decision by a taxpayer to buy shares in anticipation of a potential future buyback is simply the result of a well functioning, fully informed capital market and not a situation which needs to be addressed by legislative change. While a buyback may be foreshadowed, a change in circumstances may well mean that the buyback transaction does not proceed.

- One approach suggested is that investors be prevented from benefiting from franking credits where shares are purchased after the announcement of a buyback. That is, (having regard to the T + 3 settlement period under the ASX trading rules) an investor would need to enter into a contract to purchase shares four days prior to the announcement of the buyback. The Institute does not support such a legislative change. As noted above, if 45 days (or some lesser period) is considered an appropriate period in which to measure risk, the fact that a taxpayer may make a conscious decision to acquire shares, hold them for the relevant period and be sufficiently at risk, should be enough to qualify for a franking credit benefit and the investor should not be disentitled simply because it acted on the basis of information publicly available in the market.

- The implicit concern of the review appears to be investors buying shares with the intention of qualifying for franking credit benefits. It is acknowledged that any attempt to insert a purpose test into the 45-day rule would be problematic. In any event, investors' purposes change over time and such an approach would not be recommended.

- Another approach would be to legislate (presumably from a Corporations Act perspective) to limit the period between which a buyback can be announced and the transaction effected. Subject to the determination of what would be an appropriate period, investors may be disqualified from claiming franking credit benefits. However, we would not recommend such an approach since it would limit the flexibility available to boards and companies to effectively manage capital and conduct a buyback transaction.

The Institute therefore submits that there is no need to change the 45-day rule as it applies to off-market buyback transactions. That is, the rule provides a robust and generally accepted approach to be able to qualify for franking credit benefits. No distinction should be made between off-market buyback transactions and other transactions (such as a special dividend) where those rules also apply.

That said, there is nevertheless an urgent need for the Treasury to conclude its review on whether 15 days is an appropriate period in which to hold the shares to qualify for a franking credit benefit.
In paragraph 3.37 of the Discussion Paper, the issue of the operation of the holding rule on a last in first out ("LIFO") basis is canvassed. It is noted that shareholders who may otherwise satisfy the holding period rule in relation to shares they offer for sale under a buyback when the buyback opens, may be denied franking credits if they subsequently purchase additional shares before the buyback closes. The operation of the LIFO rule in this instance would disentitle a shareholder to franking credit benefits if the shares offered for sale under the buyback were subsequently accepted. It is submitted that in the context of an off-market buyback where a taxpayer has already made a decision to offer its shares for sale under the buyback arrangement (even though that offer may not be accepted subject to demand and the operation of the tender system), the fact that the taxpayer may buy an additional parcel of shares should not adversely affect the ability to utilise franking credit benefits.
We believe this aspect of the LIFO rule needs to be addressed and we would be happy to consult further in relation to the matter.

Implications of the 45-day rule – summary

(a) The Institute submits that there is no need to change the 45-day rule as it applies to off-market buyback transactions as the rule provides a robust and generally accepted approach to be able to qualify for franking credit benefits. No distinction should be made between off-market buyback transactions and other dividend-based transactions (such as a special dividend).

(b) On a related matter, the Institute believes that there is an urgent need for the Treasury to conclude its review on whether 15 days is an appropriate period in which to hold the shares to qualify for a franking credit benefit (as recommended by the RBT).

(c) We are also of the view that the operation of the LIFO rule in regard to the purchase of additional shares needs to be addressed.

5. Resident to resident streaming

5.1 Clear policy intent regarding wastage of imputation benefits on dividends to non-residents

The policy of the tax law in relation to the dividend imputation system was clear, in that there should not be a streaming of franking credits away from non-residents in favour of residents. In other words there should be an element of wastage in relation to the franking credits otherwise attributable to non-residents. This is clearly evident from the dividend streaming measures introduced into the imputation rules.

5.2 Clear policy of non-wastage in relation to imputation benefits on dividends to residents

Within the class of Australian residents, there are now as there always have been different tax rates applicable to Australian shareholders depending on whether they are companies or superannuation funds or high income individuals or low income individuals or non-taxed entities.

At one time, Australian taxable investors were not entitled to refunds of excess imputation credits in excess of their underlying tax liability. Similarly exempt Australian funds were not entitled to refunds of imputation credits in relation to dividends received.

However the Government introduced, as part of the simplified imputation system, a mechanism for refundable tax credits in respect of imputation benefits, in *New Business Tax System (Miscellaneous) Act (No.1) 2000* introduced into parliament expressly to provide for refunds to be offered to lower-taxed and tax exempt investors.

Given the clear intention of the parliament that lower-taxed and non-taxed Australian taxpayers should be entitled to cash refunds representing imputation credits in relation to their franked dividends, it is problematical to have the ATO interpreting the rules around off-market share buybacks so as to distinguish against non-taxed shareholders.

We note that it is open to parliament to alter the refundability of our franking credits to untaxed charities, religious bodies, research and public benefit charitable institutions, and privately managed trusts or foundations created for such purposes. The government could determine that any one or more of the parties in this sector should no longer be entitled to refunds of imputation benefits. Pending that decision however, it seems inappropriate for there to be an overlay of administrative practice which seems to be inconsistent with the clear policy intention of parliament expressed 7 years ago. Any such policy alternation by parliament would need to be undertaken in the light of full awareness of all surrounding factors including:

- If there was a complete withdrawal of refundability of franking credits for all nil-taxed bodies, whether they be public charities benefiting everyone or private trusts, there should need be an appreciation of the commercial impacts of this on the relevant bodies and their programs. The relevant bodies might need an increase in their funding or funds flow to compensate for these arrangements.

- To the extend that such bodies have ongoing share portfolios it would be less appropriate for refundable franking credits to be denied in relation to their enduring share portfolios as distinct from their participation in off-market share buybacks. We note that if the refundability of franking benefits was denied in relation to their enduring share portfolios, this would appear to place charitable bodies at a disadvantage in relation to their ongoing management of their funds as compared with all other Australian investors.

For this reason we think that any government policy change would need be carefully thought through and carefully targeted in the light of full policy considerations. In particular, it appears to us that if there was to be any limitation on the refundability of franking benefits then this should not, if at all possible, prejudice:

- The treatment of enduring share portfolios as distinct from individual transactions; and

- The treatment of substantial public charitable bodies and public widely held financial institutions as distinct from small privately managed entities.

5.3 Dividend streaming rules do not apply to transactions involving residents entitled to imputation benefits

The dividend streaming rules were reintroduced in *New Business Tax System (Imputation) Bill 2002*.

The definition of dividend streaming is quite precise. It applies to a situation where:

a) one taxpayer has an entitlement to imputation benefits and
b) another taxpayer does not

and the company undertakes streaming actions distinguishing between the shareholders.

The concept of dividend streaming does not extend, in our view, to transactions involving two different shareholders both of which are entitled to imputation benefits. This parliamentary intention is evidenced in the explanatory memorandum to the Bill:

> "3.7 To gain a full understanding of the anti-streaming rules it is necessary to understand the underlying policy.
> …
> **3.9 A consequence of generally spreading imputation benefits evenly across members is that members who cannot use, or cannot fully use, imputation benefits will nevertheless receive franked distributions**. This results in the 'wastage' of those benefits, which is a design feature of the imputation system. Wastage of imputation benefits also includes the failure to use franking credits attributable to profits that are never distributed.
> …
> ***What is streaming?***
>
> 3.28 Streaming is selectively directing the flow of franked distributions to those members who can most benefit from imputation credits.
>
> 3.29 The law uses an essentially objective test for streaming, although purpose may be relevant where future conduct is a relevant consideration. It will normally be apparent on the face of an arrangement that a strategy for streaming is being implemented. The distinguishing of members on the basis of their ability to use franking benefits is a key element of streaming.
>
> 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. However, where one class is predominantly able to use imputation credits, and the other is predominantly not,** it may be apparent that an arrangement is streaming, notwithstanding the presence in each class of a small minority of the other type of member.
>
> 3.31 Broadly speaking, **any strategy directed to defeating the policy of the law by avoiding wastage of imputation benefits** through directing the flow of franked distributions to members who can most benefit from them to the exclusion of other members, may amount to streaming. While it is not possible to specify in detail every combination of circumstances which can constitute the streaming of franking credits (which in some cases may involve questions of degree), some guidance is given below.
> …
> 3.32 In the simplest case of streaming, the members who can benefit from imputation credits receive a franked distribution, while members who cannot benefit to the same degree (e.g. non-residents) **or who receive no benefit** (e.g. tax-exempt organisations) simultaneously receive an unfranked distribution (normally adjusted in amount for the lack of franking).
>
> ***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:
- the residency of the members (non-residents cannot fully use imputation credits) [Schedule 1, item 1, paragraph 204-30(8)(a)];
- 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)];
- if one of the members is a corporate tax entity, whether it would not be entitled to franking credits (e.g. because it is a mutual life insurance company) [Schedule 1, item 1, paragraph 204-30(8)(d)]; and
- if one of the members is a corporate tax entity, whether it would be unable to make a franked distribution to its members (and therefore would be unable to distribute the franking credits it has received) [Schedule 1, item 1, paragraph 204-30(8)(e)].

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. (emphasis added)"

These clear words do not support any argument that the dividend streaming rules apply to transactions involving two different shareholders **where both shareholders or types of shareholders** are entitled to imputation benefits.

5.4 Part IVA has questionable application to transactions involving residents entitled to imputation benefits

Section 177EA of the ITAA 1936 was included in the general anti-avoidance rule of Part IVA to provide powers for the Commissioner of Taxation to take action leading to the creation of a franking debit or cancellation of franking credits.

Section 177EA is somewhat ambiguous in its application to off-market share buybacks and on one analysis is in fact inapplicable to off-market share buybacks and might be challenged if litigated in a court.

Section 177EA provides, very broadly that:

- If there is an arrangement for a frankable distribution to be paid or to flow to a particular person; and
- Having regard to the relevant circumstances of the scheme it would be concluded that the person or any person who entered into or carried out the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit (refer section 177EA (3) the Commissioner is permitted to determine a franking debit or deny a franking credit.

The key focus then is on what are the relevant circumstances of a scheme which would cause an objective determination that the relevant person had a purpose of enabling the obtaining of an imputation benefit. The relevant circumstances are detailed in section 177EA (17) in a lengthy manner, and include:

> "(b) whether the relevant taxpayer would...derive a **greater benefit from franking credits than other entities who hold membership interests**, or have interests in membership interests, in the corporate tax entities." (emphasis added).

The determination of greater benefits is the subject of subsections 177EA (18) and (19).

So, the effect of section 177EA is a focus on the entry of a person into the scheme to obtain an imputation benefit and some complex rules about determining the relevant circumstances of a scheme and whether a taxpayer is in a greater position than others to obtain an imputation benefit.

It is by no means clear that an off-market share buyback involving existing shareholders would attract s.177EA.

More significantly, however, from a fundamental structural viewpoint the Institute is concerned that s.177EA is problematical in terms of its application to off-market share buybacks and similar capital instruments. In particular, s. 177EA involves potential penalties of 200% imposed in relation to the company or to investors which, even if there is a disagreement or litigation, means that a company's public reputation will be affected pending resolution of the matter in a test case, with shareholders having their own penalty exposures.

In the circumstances, it is undesirable for the regulation of off-market share buybacks by the Commissioner of Taxation to be by use of the general anti-avoidance rule.

The Institute recommends therefore that any regulatory power by the Commissioner of Taxation, leading to adjustment of the franking account outcomes in relation to off-market share buybacks, should be excised from section 177EA and should be relocated into the simplified imputation system rules.

Resident to resident streaming – summary

(a) The Institute notes the clear policy of government on non-wastage in relation to imputation benefits on dividends to residents (as opposed to non-residents). Any government policy change would need to be carefully thought through in the light of full policy considerations.

(b) The Institute is of the view that the dividend streaming rules do not apply to transactions involving two different shareholders **where both shareholders or types of shareholders** are entitled to imputation benefits.

(c) It is by no means clear that an off-market share buyback involving existing shareholders would attract section 177EA.

(d) The Institute recommends that any regulatory power by the Commissioner of Taxation, leading to adjustment of the franking account outcomes in relation to off-market share buybacks, should be excised from section 177EA and relocated into the simplified imputation system rules as use of the general anti-avoidance rule in this context is undesirable.

6. Discount to market value – Arbitrary limit set by the ATO

The Institute does not agree with the arbitrary limit of 14% placed on the discount allowed to be given as a tender price in an off-market buyback.

There is no transparency as to how a number of 14% was determined to be the appropriate level of discount. In the Institute's view, the level of discount at which only low-taxed or tax exempt entities would participate (explanation provided for the 14% in PS LA 2007/9) is largely a function of the capital/profit split and the level of franking of a particular buyback. Accordingly, differing circumstances will mean differing level of appropriate discount. In some cases, 14% is too low and in others 14% is too high.

The Institute submits that the level of discount should not be restricted at all but should be determined by a free market. While it is acknowledged that it is possible only tax exempt entities would participate (i.e., that the discount offered by tax exempt entities is sufficiently high to economically exclude offers made by higher-taxed entities), economically a free market allows the benefit of the franking credit to be priced appropriately.

This leads to a more efficient capital market and we understand that it would also allow companies realize the full value of the EPS benefits associated with off-market buybacks and potentially can reduce the level of anticipatory trading in advance of a buyback.

The 14% discount cap was introduced by the ATO as the level of discount that would not indicate significant streaming between resident to resident shareholders. If the mischief that the ATO is seeking to prevent is low-taxed or tax exempt entities purchasing into the company predominantly to participate in the buyback, preventing other taxpayers (such as complying superannuation funds or Australian resident individuals) from participating in the buyback and attracting the receipt of franking credits, we submit that this use of the franking credit anti-avoidance provisions is not appropriate. As noted in the section entitled "Resident to resident streaming" (Section 5), it is the Institute's view that the policy behind the anti-streaming and franking credit trafficking provisions is targeting non-resident to resident streaming and not resident to resident streaming. Accordingly, it is not appropriate for the anti-avoidance provisions to be used as a cap on the discount to prevent resident to resident streaming. (We note that non-resident to resident streaming has already been taken into account in the franking debit for the proportion of non-resident shareholders in a company). See also our discussion in relation to the use of franking credits (section 2).

In this regard, if one of the mechanisms being considered to prevent taxpayers buying into a buyback for the franking credit benefit is to disallow the franking offset for shareholders who have bought shares after the announcement date, the Institute submits that such a mechanism should not be universally applied. For example, it cannot apply to a buyback which is compulsory on its members. In the latter situation, the mechanism could cause shareholders to vote down the buyback proposal (if a shareholder meeting is required as part of a buyback) or adversely affect the price traded for the share between the announcement date and the ex-entitlement to buyback date.

Discount to market value - summary

(a) The Institute does not agree with the arbitrary limit of 14% placed on the discount allowed to be given as a tender price in an off-market buyback and submits that the level of discount should not be restricted at all but determined by a free market.

(b) We reiterate our view that the policy behind the anti-streaming and franking credit trafficking provisions is targeting streaming to residents of dividends which would otherwise pass to non-residents so it is not appropriate for the anti-avoidance provisions to be used as a cap on the discount to prevent resident to resident streaming.

7. Capital dividend split

Broadly, while PS LA 2007/9 suggests that “[i]n the absence of exceptional circumstances, Average Capital Per Share will be applied” at paragraph 12, it is noted that the practice statement does outline circumstances where the slice approach and the embedded value approach may be adopted. As identified in PS LA 2007/9, there are circumstances where it would be considered acceptable to use the slice approach or the embedded value approach. However, due to the interaction of a number of integrity provisions (namely section 45B of the ITAA 1936, section 177EA, and section 204-30), it is often difficult to specify when alternative methods would “generally” provide an acceptable outcome that would not result in the application of the integrity provisions.

However, in order to ensure a reduction in compliance costs, and to provide greater certainty, we would first recommend that a “safe harbour” capital/dividend split be provided for in the legislation. This should have appropriate links to all integrity provisions such as s.45B, s.177EA, and s.204-30 where that safe harbour method is used, such that a “safe harbour” share buyback would be completely hard wired. There is a concern that such an approach could result in a view being adopted (by the ATO) that an alternative approach should (or would) result in an application of the integrity provisions. As identified in PS LA 2007/9, alternative methods are acceptable in certain circumstances. Accordingly, any legislative approach suggested above should be coupled with an allowance for an alternative approach to be accepted by the Commissioner – whereby the legislation could suggest conditions that would be required to be satisfied where an alternative approach is taken.

In the alternative, we would prefer safe harbour methods to be provided for in an ATO binding document (such as a Taxation Ruling(s) or Taxation Determination(s)), rather than being contained in a non-binding form of a practice statement. While we acknowledge that the approach provided by the ATO in PS LA 2007/9 may be considered a flexible approach that can already provide for compliance saving (i.e. through the average capital per share method being considered a safe harbour), we believe that additional compliance could be saved where taxpayers can rely on a binding document provided by the ATO. This alternative approach could help to reduce the number of private binding rulings (PBRs) required on a share buyback where the conditions of the ATO binding document are satisfied.

Capital dividend split – summary

(a) The Institute recommends that a "safe harbour" capital/dividend split be provided for in the legislation to ensure a reduction in compliance costs and to provide greater certainty.

(b) Any legislative approach should be coupled with an allowance for an alternative approach to be accepted by the Commissioner – whereby the legislation could suggest conditions that would be required to be satisfied where an alternative approach is taken. (See section 9 on ATO administration).

8. Capital losses

In general, the Discussion Paper highlights a number of possible changes to the capital loss treatment for off-market share buyback arrangements and questions the appropriateness of providing capital losses to certain taxpayers.

In general, the Institute would not support or advocate a change to remove the ability to claim capital losses under an off-market share buyback. As demonstrated in paragraph 3.50 of the Discussion Paper, the availability of a capital loss helps reduce the instance of double taxation. However, the availability of a capital loss does not always remove all instances of double taxation. Accordingly, we would be concerned with any recommendations that would advocate a possible increase in instances where double taxation may occur under the income tax law.

We also raise the following items for consideration by the Board.

8.1 Treatment of capital losses for companies

The paper is silent on the treatment of capital losses for companies under subsection 159GZZZQ(8) of the *Income Tax Assessment Act 1936* (ITAA 1936), and whether this treatment is acceptable from 1 July 2002. Prior to 1 July 2002, a capital loss generated by a company from an off-market share buyback was reduced under subsection 159GZZZQ(8) to the extent that the dividend component was treated as a rebateable dividend. From 1 July 2002, rebateable dividends (for companies) was replaced with the corporate tax offset and gross-up rules contained in Division 207, which are broadly applied in a similar manner for all other taxpayers[2].

Broadly speaking, given the similar tax outcomes that occur for all entities under Division 207, we question whether the policy in subsection 159GZZZQ(8) should continue to apply to companies (for example, as opposed to an individual taxpayer on a tax marginal rate of 30%). Subsection 159GZZZQ(8) appears to result in a different tax outcome for taxpayers (by an entity other than a company) that invest through an interposed company, as opposed to a direct investment (by an entity other than a company) in the company whose shares are being bought back.

8.2 Double taxation consequences

The Discussion Paper highlights a view (at paragraph 3.50) that double taxation consequences under a share buyback are reduced due to the availability of a capital loss to shareholders. We note, however, that this assumes that a taxpayer generates a subsequent capital gain, and that the subsequent capital gain will be utilised in the same income year (i.e. the example ignores the time value of money, and assumes that capital losses are readily useable to their full extent). It is noted that, to this effect, that while capital losses have benefit to taxpayers, it is generally something less than 100% of the tax loss.

Capital losses – summary

(a) In general, the Institute would not support a change to remove the ability to claim capital losses under an off-market share buyback as the availability of a capital loss helps reduce the instance of double taxation. We note however, that while capital losses have benefit to taxpayers, it is generally something less than 100% of the tax loss

(b) The Institute submits that the treatment of capital losses for companies under subsection 159GZZZQ(8) of the ITAA 1936 needs to be addressed in terms of whether this treatment is acceptable from 1 July 2002.

[2] But for the treatment of refundable offsets under Division 67 for all entities other than companies, and the conversion of excess credits to loss rules under Division 36 for companies.

9. ATO Administration – Reducing compliance costs and the need for class rulings

In relation to ATO administration and compliance aspects of the off-market buyback rules, the Institute submits that streamlining in this area would achieve significant cost savings, both from the perspective of companies undertaking buybacks and for the ATO in administering the rules.

While the Institute agrees that the Practice Statement recently released by the ATO (PS LA 2007/9) is helpful in obtaining some level of transparency around the class ruling process, the Institute submits that it does not provide the level of certainty required to remove the need of companies to obtain class rulings for the benefit of their shareholders. The class ruling process adds significant cost and time to the buyback.

The Institutes notes that the Board indicated that the ruling process takes up to 8 weeks to complete. Based on the experience of the Institute's members, 8 weeks is a relatively quick turnaround but more often, the time frame is between 3 to 4 months (and sometimes longer). Also, it does not factor in the time required to prepare the application which can be a number of weeks.

A class ruling is required by companies (and more specifically, the board of directors of the company) to ensure that, as a matter of good corporate governance, there is certainty of outcome for shareholders - as a class ruling is binding on the ATO. The uncertainty as to outcome of a share buyback is driven by several anti-avoidance provisions which give the Commissioner very broad discretionary powers to penalise a transaction. The provisions are sections 45B of the ITAA 1936, sections 204-30 and s177EA of the ITAA 1936. Tax advisers are generally not in a position to provide "sign-offs" in relation to these provisions and this necessitates a class ruling from the ATO.

Therefore, the Institute would welcome measures that address the uncertainties around the tax outcome of an off-market buyback in a manner that enables tax advisers to provide the company with an appropriate level of certainty without obtaining class rulings. Currently class rulings are required in addition to tax advisers' sign offs (generally on the transaction).

The Institute considers that there are, in broad terms, two approaches that can be pursued to provide certainty:

1. Legislative Changes – such as safe harbours; or

2. Administrative Rulings – e.g., tax rulings and determinations which are, *prima facie*, legally binding on the Commissioner.

The Institute submits that the preferred approach is legislative change. This is because the Institute believes that administrative rulings could be restrictive in practice (and therefore there is still a need for class rulings). For example:

(a) The Institute is concerned that the ATO may not agree or be able to provide a ruling curtailing their power in relation to anti-avoidance provisions to a class of transactions generally and unequivocally;
(b) The Institute notes that ATO rulings and determinations are only legally binding if circumstances of the taxpayer are covered by the scope of the ruling. The Institute is concerned that any ruling provided by the ATO would be narrow in application or that the ruling will state general principles but the actual ATO approach would still depend on "facts and circumstances" of each case.

Legislative change is more absolute and, if properly drafted, provide the required level of certainty. However, the Institute acknowledges that legislative change is more rigid in operation and can be less flexible than administrative rulings in dealing with changing circumstances of the economy. Accordingly, to maintain flexibility, the Institute submits that the legislative change should be in the form of an elective concessionary treatment. If a company does not wish to elect the concessionary treatment, it can still avail itself to the class ruling process.

The concessionary treatment could be in the nature of safe harbours (e.g., safe harbours in thin capitalisation rules in Division 820 and in debt deductions in section 25-85). Items that may be covered are in relation to market value of share bought back (as required to be determined by subsection 159GZZZQ(2) of the ITAA 1936), capital and profit split and franking debit that may arise from sections 204-30 and 177EA of the ITAA 1936.

The starting position would be to consider safe harbours as applying to off-market buybacks for listed and unlisted companies. However, as noted elsewhere in this submission, there are different considerations involved in unlisted company buybacks and therefore the Institute recommends that appropriate consultation take place to determine whether one or two sets of safe harbours are required (one for listed and one for unlisted companies). The Institute would welcome the opportunity to be part of the consultation process.

The Institute is also of the view that to maintain flexibility it must be made very clear (whether by provisions of the legislation or in the explanatory memorandum) that the safe harbours are not intended to be the only appropriate way in determining the outcome of the provisions. For example, the legislation could specifically allow as an alternative to safe harbours, ability for taxpayers to approach the Commissioner for a decision and list relevant factors and circumstances (drafted broadly) that the Commissioner must consider in making his or her decision. When approached by companies, the Commissioner must consider all relevant circumstances in forming its decision.

The Institute would be pleased to participate in further consultation and discussion in relation to the above.

ATO Administration – summary

(a) The Institute submits that streamlining ATO administration and compliance aspects of off-market share buybacks would achieve significant cost savings. The Institute considers that although promoting transparency, the practice statement, PS LA 2007/9, does not provide the level of certainty required to remove the need of companies to obtain class rulings.

(b) The Institute considers that there are, in broad terms, two approaches that can be pursued to provide certainty – being legislative change (such as safe harbours) or binding administrative rulings. The Institute submits that the preferred approach is legislative change as it is more absolute and, if properly drafted, will provide the required level of certainty. To maintain flexibility, the legislative change should be in the form of an elective concessionary treatment.

(c) The concessionary treatment could be in the nature of safe harbours. Items that may be covered are in relation to market value of the share bought back, capital and profit split and franking debit. The legislation should also specifically allow as an alternative to safe harbours the ability for taxpayers to approach the Commissioner for a decision.

(d) The Institute recommends that appropriate consultation take place to determine whether one or two sets of safe harbours are required (one for listed and one for unlisted companies).

10. Share buybacks and unlisted companies

The Discussion Paper tends to group listed companies with widely held unlisted companies, and the Institute's comments above regarding the rationale for off-market share buybacks and the impact of the current tax framework on listed companies are, where indicated in our submission, equally applicable to widely held unlisted companies.

However, in this section of the submission we have set out some issues that are specific to unlisted companies.

10.1 Shareholder tax profiles - broader issues are at stake than share buybacks

Whilst the Institute acknowledges the revenue considerations relating to shareholder tax profiles (para 4.29 et seq), the Institute points out that these considerations are an outcome of the design features of the dividend imputation system, and raise issues which are much broader than the interaction of the share buyback rules with the imputation system. Moreover, these considerations were well known to Treasury when they advised the then Labor Government on the introduction of the imputation system, and had been the subject of analysis in New Zealand.[3]

[3] Refer Matt Benge and Tim Robinson, How to integrate company and shareholder taxation: Why full imputation is the best answer, Victoria University Press, Wellington, 1986.

The Institute also notes the dichotomy which has arisen in the tax law between closely held companies and closely held trusts, with the latter able to stream franking credits and cater for beneficiary tax profiles provided that a family trust election has been made. It would seem a strange result indeed if further restrictions were placed on the return of dividends and capital to shareholders of an unlisted company, and yet allow trusts to retain such advantages. Indeed, this raises a much broader question as to whether it is time for Australia to embrace a "small unlisted company" tax regime (adopted in other jurisdictions) which removes some of the impediments which currently apply to all unlisted companies, and "de-clutters" the tax legislation in so far as the application of anti-avoidance rules to small companies is concerned. The Institute does not however support any piecemeal introduction of such changes in relation to share buybacks.

10.2 Unlisted companies need flexible commercial options when restructuring

The Institute agrees with the Board's summary of possible alternative arrangements for the restructuring unlisted companies (para 2.18) and notes that a range of commercial considerations will come into play in deciding which approach will be adopted by the directors of an unlisted company.

In particular, the Institute notes that the company's ability to source the necessary funds to buy back the shares (para 2.19) is a common commercial reality. There is usually a strong correlation between tax and business considerations in such cases (i.e. the deduction generally available for gearing at the corporate level to fund a buyback reflects the commercial reality that interest outlays can be matched against the revenues generated by the company from its day-to-day business activities): refer also Roberts & Smith (1992) 23 ATR 494; 92 ATC 4380, and TR 95/25.

Although pre-emption arrangements are often in place between members of unlisted companies, it is often the case that such arrangements come unstuck when it comes to sourcing the funds necessary to make shareholder-to-shareholder payments. Hence, share buybacks are a popular alternative strategy.

Selective buybacks are also an option, but although the 1998 Corporations Law reforms have facilitated such arrangements, members report that unlisted corporates encounter great difficulty in obtaining ATO clearance for such transactions. In practice, a degree of selectivity is obtained by undertaking an initial share buyback for all shareholders, followed by the issue of new shares to continuing shareholders in the unlisted company.

10.3 Off-market share buybacks and the SME sector - Practical difficulties in obtaining ATO clearance - The anti-avoidance rules

As noted in the Discussion Paper, off-market share buybacks are used by unlisted companies to make changes in ownership structures, and the Institute agrees that the current tax rules are a particularly important part of succession planning in the SME sector of the business community (refer para 2.13). As an organisation whose members frequently advise corporates in the SME sector, the Institute feels strongly that the tax law should not operate in a manner which makes it harder for unlisted companies to undertake share buybacks.

Unfortunately, members have reported difficulties in obtaining favourable ATO private rulings on unlisted company share buybacks, particularly in relation to the application of capital and dividend streaming provisions. This feedback raises concerns about ATO resourcing and the commercial experience of ATO officers handling such ruling requests (addressed elsewhere in this submission). More importantly however, it highlights a much broader efficiency problem: the plethora of anti-avoidance provisions to counter tax planning arrangements which - from a revenue perspective - cater for shareholder tax profiles rather than commercial objectives. As noted above, this raises issues which go beyond off-market share buybacks, and relate to the dividend imputation and capital return provisions of the law more generally.

In view of the broad scope of the anti-avoidance provisions, the Institute finds it difficult to put forward any "bright line" rules which would remove the need for private rulings, or enable the ATO to deal with private ruling request more quickly, unless a broader "small unlisted company" regime is created which addresses not just share buyback approvals, but other features of the tax law which impose compliance burdens on such companies (see above).

Nonetheless, consideration could be given to an ATO review of its private rulings and internal precedents where anti-avoidance provisions have been found to apply (or not to apply) in unlisted share company buybacks, collate these, distil the key considerations, and publish as a public ruling, on the understanding that taxpayer's can self assess the application of that public ruling to their own circumstances. The Institute would be willing to work with the ATO on the development of such a ruling.

10.4 Valuation issues and unlisted companies

The Institute agrees with the Board's comments at para 3.28 regarding valuation issues. In practice, Institute members are often called upon to provide shareholders with a valuation range or an actual valuation, struck at a time as agreed between shareholders. Often, this exercise is facilitated by selecting a time when the annual accounts for the relevant entity are prepared. Although the closely held nature of most unlisted companies may suggest otherwise, shareholders can generally be relied upon to act in their own self-interest and the shareholder collusion over a valuation is generally rare and, in any event, the existing law is considered to provide the revenue with adequate safeguards in this regard. The Institute concurs that tender arrangements for establishing the buyback price are rarely, if ever, used in the unlisted company sector (para 4.23).

The Institute notes that the ATO has in recent years issued guidance for valuers, and these have been helpful in the context of share buyback valuation assignments.

Notwithstanding the above comments, the Institute acknowledges that valuations in the unlisted corporate sector can be contentious, and the Institute would support more specific guidelines for its members and improved documentation of valuation methodology.

Share buybacks and unlisted companies - summary

For unlisted companies, in general:

(a) the Institute sees little wrong with the drafting of the current tax rules for share buybacks in so far as they apply to unlisted companies (as reflected in the Board's comments at para 4.25). However our members report compliance difficulties in dealing with the ATO on private ruling requests relating not just to these rules, but also other provisions relevant to the return of capital or distributions to shareholders;

(b) the share buyback tax rules facilitate commercial arrangements which enable unlisted companies to restructure;

(c) the Institute does not believe that separate share buyback tax rules should apply to widely held and closely held unlisted companies, but acknowledges that this delineation raises broader tax policy questions which may be worthy of a separate consultation exercise;

(d) clear valuation guidelines and documentation arrangements would be of use to reduce disputes over valuation of shares in unlisted companies.

11. Share Buybacks and Employee Share Plans

The Discussion Paper includes the following two questions on share buybacks and employee share schemes:

4.7 Does the interaction between the provisions for taxation of off-market share buybacks and employee share schemes work appropriately?

4.8 If not, why, and what changes could be made to ensure a more appropriate interaction?

11.1 Interaction of Provisions

There are two key areas where the operation of the share plan buyback tax rules can produce outcomes that are arguably inappropriate for employee shareholders. In the first category, the buyback rules result in outcomes different to those where the shares are sold to a third party. This may for acceptable for sophisticated shareholders, but is inappropriate for the majority of employee shareholders who are less financially sophisticated. The second category identifies transactions where the buyback rules operate unfairly to buybacks implemented only to facilitate the operation of employee share plans.

(i) All shareholder buybacks

Appendix H of the Discussion Paper identifies examples in relation to discounted shares where the share buyback 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 buyback and the dividend component of the buyback exceeds the exercise discount.

There is also another logistical issue that needs to be taken into account. If disposal restrictions need to be released (thereby resulting in a cessation event under Division 13A) more than 30 days prior to a buyback occurring, significant adverse tax outcomes can arise. This occurs because the employee then pays tax under Division 13A on the discount at cessation and then again on the dividend as a result of the buyback.

(ii) Employee Share Plan only buybacks

In many cases, share buybacks could be used to facilitate the operation of employee share plans, if adverse tax outcomes didn't arise. This often means that companies must establish trusts to hold and retain shares, when buybacks could be administratively far simpler. Two examples are set out below.

(a) Share Plan Forfeitures

In many cases, shares acquired at a discount, as well as employee shares acquired at market value but funded by concessional loans, will be subject to vesting or performance conditions under which shares must be forfeited if those conditions are not met. Usually, the employee receives back the original consideration paid, but does not retain any of the increase in share value. Therefore, the employee realises neither a loss nor a gain. However, if this transaction is structured as a buyback, 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 buyback sales.

(b) Unlisted Company Share Plans

Unlisted company employee share plans often involve the employees acquiring shares at market value funded by concessional loans. The expectation is that any profit realised will be taxed as capital gain. Usually, when an employee leaves the company, they are required to sell their shares. The company will usually also provide other windows where employees can sell their shares should they wish. Often the company will be required to create a market by funding these share purchases.

Again, an administratively simple means to achieve this would be to buyback the shares at the agreed price. However, under current rules, this would result in a component of the consideration being taxed as a dividend rather than capital gain, with the employees potentially worse off.

From the company perspective, the employer potentially needs to obtain a ruling from the ATO every time, in order to establish with certainty the dividend component.

As a result, companies must establish trusts to facilitate the market in the shares, in order to avoid these consequences.

In relation to both (a) and (b), we note that if the need for a carve-out is accepted, there are a number of detail and definitional issues that would need to be addressed during any consultation process around either design of the proposals or legislation of changes.

Share Buybacks and Employee Share Plans - summary

In summary:

(a) The interaction of the current off market share buyback tax rules with the provisions for taxing employee share plans can produce adverse outcomes for employees that are neither fair nor appropriate.

(b) Off-market share buy backs could be used to a far greater extent to facilitate the operation of share plans, by both listed and unlisted companies, if the tax rules did not create adverse consequences.

(c) The Institute recommends that a carve-out from the share buyback tax rules be provided for all employee share plan transactions. Alternatively, a carve-out should apply for employee share plan buybacks that are not part of a broader buyback arrangement participated in by all shareholders.