Review of the Taxation Treatment of Off-Market Share Buybacks

A report to the Treasurer

The Board of Taxation

June 2008

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FOREWORD

The Board of Taxation is pleased to submit to the Treasurer its Report on the Taxation Treatment of Off-market Share Buybacks.

In reviewing the taxation treatment of off-market share buybacks the Board has considered the benefits that off-market buybacks can bring to companies and the operation of the capital markets, and the equity concerns that have been raised about some shareholders benefiting at the expense of others. The recommendations set out in the Report seek to weigh up these issues while providing a way forward to reduce the heavy compliance and administrative costs that the current taxation treatment can impose on taxpayers and the Australian Taxation Office.

The Board established a Working Group, chaired by Mr Brett Heading, to conduct the review. The Board held discussions with various stakeholders, taking into account the sometimes conflicting views that were put forward, in the preparation of the Discussion Paper and this Report. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided by officials from the Treasury and the Australian Taxation Office in conducting this review.

On behalf of the Board, it is with great pleasure that we submit this report to the Treasurer. The Board believes, if implemented, the recommendations in the report will considerably reduce compliance costs while maintaining the efficiency benefits of off-market share buybacks and addressing equity concerns.

R F E Warburton AO
Chairman, Board of Taxation

J B L Heading
Chairman of the Board's Working Group
Member, Board of Taxation

GLOSSARY OF TERMS

ASIC	Australian Securities & Investments Commission
ASX	Australian Securities Exchange Limited
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
EPS	earnings per share
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
LIFO	last in first out
TD	Taxation Determination
VWAP	volume weighted average price

EXECUTIVE SUMMARY

INTRODUCTION

The Board of Taxation was asked by the former government in October 2006 to review the taxation treatment of off-market share buybacks.

KEY FINDINGS

The Board has made a number of recommendations that it considers will address the considerable compliance costs faced by taxpayers and the Australian Taxation Office (ATO) from the current taxation treatment of off-market share buybacks while maintaining them as a viable option for capital management.

Some of the current complexities in compliance and administration stem from the intent of the taxation treatment to limit the unequal distribution, or streaming[1], of franking credits. The streaming of franked dividends towards those shareholders to whom they are most attractive, notably low tax rate and tax exempt shareholders, results in a reduction of taxation revenue compared to a benchmark of the franked dividends paid to all shareholders in accordance with their shareholding. Streaming also leads to criticisms that off-market share buybacks are inequitable as their benefits flow predominantly to those same low tax rate and tax exempt shareholders at the expense of other shareholders and taxpayers more generally.

In coming to its recommendations the Board has weighed the efficiency benefits that off-market share buybacks provide as a method of returning capital to investors against the equity concerns, the need to reduce complexity and compliance costs and any potential change to revenue.

The Board's key findings are that:

- the unequal distribution of franking credits that arises in off-market share buybacks conducted by listed companies reflects incentives that flow from the operation of the taxation system generally;

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1 Streaming is defined as distributions which provide imputation benefits to those shareholders in a company who are able to benefit more from the franking credits than other shareholders in that company.

- the Board accepts that this unequal distribution will occur and that the policy underlying much of the taxation treatment specific to off-market share buybacks that seeks to limit the unequal distribution of franking credits between resident shareholders should therefore be modified;

- in particular, the current cap on the extent of the discount should be removed for buybacks conducted by listed companies. This will result in significant reductions in compliance and administration costs and improve the benefits that flow to non-participating shareholders;

- notional losses[2] should be denied to shareholders participating in buybacks conducted by listed companies recognising, that removing the cap may strengthen the incentives for low rate and tax exempt shareholders to participate more heavily than other shareholders. This reflects the Board's judgment that the notional losses exacerbate the unequal flow of benefits between participating and non-participating shareholders and taxpayers more generally through the impact on taxation revenue. The Board considers that denying notional losses to participating shareholders will not undermine the viability of off-market share buybacks;

- the current policy on streaming of franking credits between non-resident and resident shareholders should be maintained;

- to the extent possible, administrative discretions that apply in the context of off-market share buybacks should be coded in legislation with only a residual discretion for specific circumstances; and

- the buyback provisions should be included in the *Income Tax Assessment Act 1997* (ITAA 1997).

Cap on level of discount

Recommendation 1

The Board recommends that there should be no cap on the level of the discount to an Australian securities exchange value of shares under off-market share buybacks conducted by listed companies.

2 References in this report to notional losses include notional capital losses as well as notional revenue losses.

Non-resident to resident streaming

Recommendation 2

The Board recommends that:

- there should continue to be a debit to the franking account of the company to reflect the intended wastage of franking credits in the hands of non-resident shareholders; and

- there should be a specific provision dealing with this issue in the context of off-market share buybacks rather than relying on the general streaming and integrity provisions. That provision should include the formula for calculation of the debit to the franking account. Franking credits will continue to be available to shareholders notwithstanding this debit to the franking account.

Notional losses

Recommendation 3

The Board recommends that:

- notional losses should be denied to all shareholders who participate in off-market share buybacks conducted by listed companies. The market value uplift rule in subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* should not apply to off-market share buybacks conducted by listed companies; and

- notional losses should continue to be allowed for shareholders who participate in off-market share buybacks conducted by unlisted companies. The market value uplift rule in subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* will continue to apply to off-market share buybacks conducted by unlisted companies.

Greater certainty for listed companies

Recommendation 4

The Board recommends:

- legislative provisions be introduced that:
  - outline the methodology for the capital/dividend split. Average capital per share should be specified as the general method to be used by companies, with a discretion available to the Commissioner of Taxation to allow companies to apply another methodology such as the slice method or the embedded value method when appropriate to their particular circumstances. The Australian

Taxation Office should provide guidance on the circumstances in which these other methodologies may be appropriate;

- specify an extension of time for listed companies conducting an off-market share buyback to provide a distribution statement; and
- confirm that sections 45A and 45B and paragraph 177EA(5)(b) of the *Income Tax Assessment Act 1936*, and section 204-30 of the *Income Tax Assessment Act 1997*, will not be applied to tender-style off-market share buybacks conducted by listed companies where average capital per share is used to determine the capital/dividend split;

• taxation rulings be issued that:

  - outline the appropriate buyback timetable; and
  - outline the application of the 45 day rule, including how LIFO (last in first out) applies in relation to off-market share buybacks conducted by listed companies.

Unlisted companies

Recommendation 5

The Board recommends the off-market share buyback provisions should generally apply in the same way to listed and unlisted companies, subject to the following modifications:

- sections 45A and 45B and paragraph 177EA(5)(b) of the *Income Tax Assessment Act 1936*, and section 204-30 of the *Income Tax Assessment Act 1997*, will continue to apply to off-market share buybacks conducted by unlisted companies; and
- the Australian Taxation Office should continue to provide guidance on market valuation for unlisted companies.

Include buyback provisions in the *Income Tax Assessment Act 1997*

Recommendation 6

The Board recommends that in amending any existing provisions that apply to off-market share buybacks, consideration be given to moving the provisions currently in the *Income Tax Assessment Act 1936* to the *Income Tax Assessment Act 1997*.

CHAPTER 1: INTRODUCTION

TERMS OF REFERENCE

1.1 On 10 October 2006 the former government announced that it had asked the Board of Taxation to undertake a review of the taxation treatment of off-market share buybacks and to provide a final report to the Treasurer.

1.2 In conducting the review, the Board was asked to take into account:

- the factors influencing the increasing trend towards the use of off-market share buybacks;
- the implications of the current taxation treatment of off-market share buybacks for different types of shareholders;
- the compliance cost impacts of off-market share buybacks;
- the administrative practices of the Australian Taxation Office relating to off-market share buybacks;
- the basis for splitting the proceeds of off-market share buybacks into a dividend component and a capital component;
- the application of the dividend streaming rules to off-market share buybacks;
- the capital gains tax implications of off-market share buybacks; and
- any other matters the Board considers to be appropriate.

1.3 As taxation arrangements for off-market share buybacks apply to both listed and unlisted companies, the Board's review covers the use of buybacks by both types of companies.

THE REVIEW TEAM

1.4 The Board appointed a Working Group of its members comprising Brett Heading (Chairman), John Emerson AM, Keith James, Eric Mayne and Dick Warburton AO to oversee its review of the taxation treatment of off-market share buybacks. The Working Group was assisted by members of the Board's Secretariat.

1.5 The Board also engaged a number of consultants to assist with the review. Professor Richard Vann (The University of Sydney) and Associate Professor Stephen Barkoczy (Monash University) provided advice on the taxation law applying to off-market share buybacks and Associate Professor Christine Brown (University of Melbourne) assisted the Board with an economic analysis of off-market share buybacks.

1.6 In addition, the Board consulted with the Treasury on the development of the current policy and legislation relating to off-market share buybacks and with the ATO about its administrative practices.

REVIEW PROCESSES

1.7 The Board has consulted widely in developing the recommendations in this report. The Board's consultation processes involved:

- preliminary targeted consultation with selected stakeholders representing the diverse range of views on off-market share buybacks;
- the development of a Discussion Paper which was released in July 2007;
- holding consultation meetings in Sydney and Melbourne during July 2007 to explore the issues raised in the Discussion Paper; and
- inviting written submissions to assist with the review.

Discussion Paper

1.8 In developing its Discussion Paper, the Board met with selected companies that had conducted off-market share buybacks, their legal and financial advisers, fund managers, representatives of a range of institutional investors, and various individuals who had expressed concerns about some aspects of off-market share buybacks.

1.9 The views received in the targeted consultation process assisted the Board in developing a Discussion Paper which was released in July 2007 to assist the consultation process. The Discussion Paper:

- provides some background to and the framework under which off-market share buybacks operate in Australia;
- outlines the tax treatment of off-market share buybacks for various types of shareholders; and
- examines issues relating to each of the review criteria mentioned in paragraph 1.2.

1.10 The Discussion Paper included a comprehensive discussion of the purpose and development of off-market share buybacks, alternative approaches to capital management and the current regulatory framework for off-market share buybacks, including the taxation treatment. This detailed information is not repeated in this Report and it is suggested that readers seeking a comprehensive overview read this Report in conjunction with the Discussion Paper.

Consultation meetings

1.11 Following the release of the Discussion Paper, the Board held consultation meetings in Sydney on 26 July 2007 and in Melbourne on 31 July 2007 to explore issues raised in this Discussion Paper and any other relevant issues. These meetings were open to all stakeholders. A list of attendees at both consultation forums is at *Appendix A*.

Submissions

1.12 The Board also invited written submissions to assist with the review. Those providing submissions were asked to address the terms of reference set out in paragraph 1.2 and the issues and questions outlined in the Discussion Paper. The Board also received a number of preliminary submissions prior to the release of the Discussion Paper. In total the Board received submissions from 37 individuals and organisations. Except for those made in confidence, submissions have been published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at *Appendix B*.

Board's report

1.13 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings. However, the Board's recommendations reflect the Board's independent judgment, after taking into account all of the information and experience available to it.

Chapter 2: Taxation framework and market processes for share buybacks

Introduction

2.1 This chapter provides a summary of the elements of the current regulatory arrangements for off-market share buybacks.

2.2 The operation of off-market share buybacks is determined by corporations law rules, securities exchange requirements, taxation law and ATO administrative practice, and general market practices. These are discussed in detail in Chapter 3 of the Discussion Paper and are not repeated here.

2.3 Share buybacks are a capital management tool used by companies to return cash to shareholders. Shares that are bought back are cancelled so there is a reduction in the number of issued shares. The *Corporations Act 2001* allows a company to buy back its shares as long as the buyback is fair and reasonable to the company's shareholders as a whole and does not materially prejudice its ability to pay its creditors.

Taxation framework

2.4 For taxation purposes, there are two types of share buybacks — on-market or off-market. Off-market share buybacks are any buybacks that are not conducted in the ordinary course of share trading on an Australian securities exchange. Since 2002, the value at which the shares are bought back in an off-market share buyback has usually been determined by a 'dutch auction' among participating shareholders. The taxation rules that apply to off-market share buybacks reflect trade-offs to ensure they do not result in better imputation credit usage than other methods of returning capital to shareholders and do not create opportunistic behaviour which is likely to require complex and costly-to-manage anti-avoidance rules.

2.5 From the company's perspective, the cancellation of its shares under a buyback has no income tax or capital gains tax (CGT) consequences.[3] A buyback may, nevertheless, have franking account consequences for the company.

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3 ITAA 1936, section 159GZZZN.

2.6 When a company buys back its shares under an off-market share buyback, the amount paid to shareholders is taken to be a dividend to the extent that the amount is drawn from the company's distributable profits. This is consistent with the general notion that any payment made by a company to shareholders, other than a return of capital, is treated as a dividend for tax purposes. Therefore, for shareholders, the tax consequences of an off-market share buyback will depend on the relative proportions in which the company has chosen to debit the purchase price against amounts standing to the credit of its share capital account and its other accounts (for example, its profits).[4] It will also depend on whether the purchase price paid for a share is greater than, equal to, or less than its price on the Australian Securities Exchange (ASX).

The dividend component of the purchase price

2.7 The consideration paid to a shareholder who participates in an off-market share buyback is divided into a dividend component and a capital component.

2.8 The dividend component of the purchase price is the difference between the purchase price paid by the company for a share and that part of the purchase price which is debited against the company's share capital account.[5]

2.9 As a general rule, this dividend is a frankable distribution[6] and the company may allocate franking credits to it. However, to prevent a company paying a higher franked dividend than would otherwise be possible[7], it is not frankable to the extent that the purchase price exceeds 'what would be the market value of the shares at the time of the buyback if the buyback did not take place and was never proposed to take place'.[8]

Capital component of the purchase price

2.10 The capital component is that part of the purchase price which is debited against the company's share capital account. While the capital component is nominated by the company, it needs to be determined using a methodology acceptable to the ATO in order to avoid the application of various anti-avoidance rules.

2.11 In particular, where the purchase price is less than the amount that would have been the market value of the share at the time of the buyback 'if the buyback did not occur and was never proposed to occur', the capital component received by a

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4 If a non-share equity interest is being bought back, instead of a share, it is the proportions in which the company chooses to debit the purchase price against amounts standing to the credit of its non-share capital account as opposed to other accounts that are relevant.

5 ITAA 1936, section 159GZZZP.

6 ITAA 1997, section 202-40.

7 See further, Explanatory Memorandum to the Taxation Laws Amendment Bill (No.1) 1996, paragraph 2.15.

8 ITAA 1997, paragraph 202-45(c).

shareholder is adjusted. The adjustment is called the market value uplift rule[9] and has the effect that the consideration for the sale is deemed to be the market value of the share at that time.

2.12 The application of the market value uplift rule to off-market share buybacks conducted by listed companies is outlined in TD 2004/22. Generally, shareholders who sell their shares into an off-market share buyback can realise a notional loss. The loss is magnified by shares bought back at a discount to market value. The market value uplift rule prescribes a methodology to reduce the capital loss by way of a market value adjustment.

2.13 The market value uplift rule requires the market value of a share to be calculated on the premise that the buyback was never announced and never took place. The methodology adopted by the ATO for this calculation is based on the volume weighted average price (VWAP) of the company's share on the ASX over the last five trading days before the announcement of the buyback, adjusted for the percentage change in the S&P/ASX 200 Index (or another approved index) from the commencement of trading on the first announcement date to the close of trading on the day the buyback closes.

Anti-avoidance provisions

2.14 Specific anti-avoidance provisions target particular arrangements on both the dividend and capital sides, such as franking credit trading and streaming schemes. The anti-avoidance provisions may result in shareholders being denied franking credit tax offsets, penalty debits arising in companies' franking accounts or capital benefits being treated as unfranked dividends.

2.15 The most important anti-avoidance rules in the context of share buybacks are:

- the qualified person rule (referred to in Taxation Determination 2007/11);
- the anti-dividend streaming rule (contained in section 204-30 ITAA 1997);
- the capital benefit streaming and substitution rules (contained in sections 45A and 45B *Income Tax Assessment Act 1936* (ITAA 1936)); and
- the general anti-avoidance provision for franking credit trading (contained in section 177EA ITAA 1936).

2.16 The anti-avoidance provisions (in paragraph 177EA(5)(a) of the ITAA 1936) have been used by the ATO to determine a debit to the franking account of the company undertaking the off-market share buyback for the imputation credits in respect of non-resident shareholders.

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9 ITAA 1936, subsection 159GZZZQ(2).

The qualified person (45 day) rule

2.17 Only a qualified person is entitled to franking credits in respect of dividends. To be regarded as a qualified person a shareholder must satisfy both a related payments rule and a holding period rule. These rules were not designed specifically to deal with off-market share buybacks but were introduced to deal with securities lending and similar arrangements.

2.18 The related payments rule will not be satisfied if the shareholder (or associate of the shareholder) is under an obligation to make, or makes, a payment in respect of the dividend which effectively passes the benefit of the dividend to another person.

2.19 The holding period rule requires a shareholder to hold the shares, or interests in the shares, in respect of which the dividend is paid for a continuous period of at least 45 days (90 days for preference shares).[10] This period does not include the acquisition and disposal date or days on which the taxpayer has materially diminished risks of loss and opportunities for gain in relation to the shares, or interests in the shares.[11]

2.20 The holding period rule generally operates on a LIFO basis. Shareholders are deemed to have disposed of their most recently acquired shares first. This means that shareholders who satisfy the holding period rule in relation to shares they offer for sale under a buyback when the buyback opens, may, in some circumstances, be denied franking credits if they subsequently purchase additional shares before entitlement to participate in the buyback closes.

The anti-dividend streaming rule

2.21 The Commissioner of Taxation (Commissioner) has a discretion to deny the benefits of streaming if a company streams distributions in such a way that:

- an imputation benefit is, or would be, received by a shareholder as a result of the distributions;
- the shareholder would derive a greater benefit from franking credits than another shareholder; and
- the other shareholder will receive lesser imputation benefits, or will not receive any imputation benefits, regardless of whether they receive other benefits.

2.22 Where these criteria are satisfied, the Commissioner may determine that:

- the franking account of the company should be debited; and/or

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10 An individual shareholder with franking credits of $5,000 or less is not subject to the holding period rule.

11 This will be the case if the 'net position' of the shareholder results in the shareholder having less than 30 per cent of the risks and opportunities relating to the shares, or interests in the shares.

- the shareholder who receives greater benefits should be denied the imputation benefit.

The capital streaming and dividend substitution rules

2.23 Sections 45A and 45B apply to arrangements involving the provision of capital benefits. A taxpayer obtains a benefit where the tax payable by the relevant taxpayer would be less than the amount that would have been payable if the capital benefit had been an assessable dividend. The provision of capital benefits can arise where a company distributes share capital (for example, under a buyback). Where the requirements of the sections are met, the ATO may treat some or all of the capital benefits as unfranked dividends.

2.24 Section 45A applies where a company streams the provision of capital benefits and the payment of dividends to its shareholders in such a way that:

- capital benefits are received by shareholders who would derive a greater benefit from the capital benefits than other shareholders; and
- it is reasonable to assume that the other shareholders received or will receive dividends.

2.25 Section 45B applies where:

- there is a scheme under which a person is provided with a capital benefit;
- under the scheme a taxpayer, who may or may not be the person provided with the capital benefit, obtains a tax benefit; and
- having regard to the circumstances of the scheme, it would be concluded that a person who entered into the scheme did so for a purpose (other than an incidental purpose) of enabling the taxpayer to obtain a tax benefit.

The anti-franking credit trading scheme rule

2.26 This rule applies where under a scheme a franked distribution is paid, is payable or flows indirectly to a person where it would be concluded that a person entered into the scheme for a purpose (other than an incidental purpose) of obtaining an imputation benefit.

2.27 An imputation benefit arises if, as a result of the distribution:

- a person is entitled to a franking credit; or
- a credit would arise in a company's franking account.

2.28 In these circumstances the Commissioner has the discretion to make a determination:

- to debit the franking account of the company; or
- that no imputation benefits arise in respect of the distribution or part of the distribution.

2.29 Professor Vann in his advice to the Board noted that the anti-avoidance provisions apply to investors who buy into a buyback to obtain franked dividends and not to the shareholders in existence before the off-market share buyback process:

> …it is concluded that neither s 204-30 nor s 177EA will generally be applicable to resident to resident streaming of imputation credits … although the latter provision can be applied to trading in imputation credits with respect to shareholders who buy into a buyback to get franked dividends.

AUSTRALIAN TAXATION OFFICE PROCESSES

2.30 The ATO has issued tax determinations, class rulings and private rulings and has released a practice statement concerning off-market share buybacks. Public rulings, private rulings and practice statements are addressed in more detail in Chapter 3 of the Discussion Paper.

2.31 Almost all public companies engaged in an off-market share buyback seek a class ruling (in respect of their shareholders) and sometimes a private binding ruling (in respect of themselves). This imposes a considerable compliance cost on taxpayers and an administrative cost on the ATO.

2.32 The guidance provided by the ATO includes:

- a tax determination (TD 2004/22) on the method for calculating the market value of shares in relation to off-market buybacks by listed companies;
- public (mainly class) rulings covering:
  - the amount of the dividend component;
  - the amount of the capital component;
  - the application of the qualified person rules; and
  - the application of the anti-avoidance provisions to the buyback;
- private binding rulings that address:
  - the determination of market value;
  - the dividend/capital split; and

  - the application of the anti-avoidance provisions; and

- practice statements that bring together the ATO views of the various matters considered in class rulings and private binding rulings.

MARKET PROCESSES

2.33 Off-market share buybacks by listed companies nowadays generally involve a tender process. Shareholders are invited to offer to sell their shares back to the company at one or more tender prices or tender discounts set by the company within a range of increments. The actual purchase price paid for a share (the buyback price) is not determined until all tenders have been submitted and the buyback closes.

2.34 Shareholders may offer to sell their shares at a final price, which is at whatever price is ultimately determined under the tender process.[12] Shareholders that offer to sell their shares at tender discounts are usually given the opportunity to nominate minimum prices below which they will not sell their shares. This protects them against the consequences of adverse movements in the market value of the shares occurring after the tender is made but before the buyback closes.

2.35 Tenders at a price above the buyback price will be rejected and the shares will not be bought back. Tenders at or below the buyback price, or as a final price tender, are successful and the shares are bought back, subject to any scale-back. All shareholders successfully bidding receive the same price.

2.36 A scale-back arises where there is an excess of tenders. This arises where the total number of shares tendered at or below the buyback price is greater than the number of shares the company wishes to buy back. In this case, the number of shares bought back is scaled back on a pro-rata basis among shareholders. However, the scale-back usually operates subject to priority allocations and small holding allocations. Priority allocations ensure that the company buys back a specified minimum number of a shareholder's shares that are tendered at or below the buyback price. Small holding allocations ensure that shareholders that tendered all their shares at or below the buyback price and who are left with only a small number of shares after the priority allocation has taken place have all their shares bought back.

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12 'Tender prices' are specific dollar amounts, while 'tender discounts' are expressed as a percentage discount to the market value of a share (determined in accordance with formulae specified in the buyback documents).

CORPORATIONS ACT AND ASIC ISSUES

2.37 The tender process for conducting off-market share buybacks does not satisfy the requirements of an equal access buyback under the Corporations Act. Although off-market buybacks are categorised as selective buybacks, generally listed companies are able to obtain approval from the Australian Securities & Investments Commission (ASIC) to treat them as equal access so long as each shareholder has the same opportunity to participate in the buyback.[13] ASIC also grants relief to allow the scale-back of the number of shares to be bought back and to allow priority allocation and priority tender arrangements.

2.38 It has been argued by some that the current arrangements for off-market share buybacks result in some shareholders receiving greater benefits than others. In particular, it is argued that by facilitating the distribution of franking credits to some shareholders and not others, companies are in breach of section 254W of the Corporations Act. It is also said that, in such circumstances, directors may be in breach of their duty to act in the best interests of the company as a whole under section 181.

2.39 However, ASIC has indicated that it does not believe that section 254W has application in the context of off-market share buybacks as, although an amount is deemed to be a dividend under taxation law, it is not a dividend for the purposes of the Corporations Act.[14] Under the Corporations Act a dividend is a distribution of profits as a reward to shareholders as the ongoing equity owners. In a buyback a lump sum payment is made by the company to participating shareholders in return for them giving up ownership in the company. ASIC considers that the dividend and buyback regimes operate quite separately.

2.40 ASIC also notes that it is the directors of a company who must be satisfied that the transaction is still in the best interests of the company as a whole. To date ASIC has not intervened in buybacks on the basis that directors were in breach of their duties.

2.41 While the Board's terms of reference allowed it to take into account any matters that it considers appropriate, this review is fundamentally about the taxation arrangements for off-market share buybacks. Although the Board is mindful of the concerns expressed by some about the application of the Corporations Act to off-market share buybacks, it considers that these concerns have been addressed by ASIC, which has responsibility for such issues. Consequently, the Board has not considered them in this review.

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13 *Corporations Act 2001*, subsection 257D(4). ASIC's policy for considering applications for exemptions is set out in Policy Statement 110. See also ASIC, *05-44* 'ASIC's Position on Off-market Share Buybacks Incorporating Fully Franked Dividends' (Media Release, 3 March 2005).

14 ASIC media and information release 05-44 of 3 March 2005, 'ASIC's position on off-market share buybacks incorporating fully franked dividends'.

Chapter 3: Key issues addressed in the review

3.1 The former government asked the Board to consider a number of features of the taxation treatment of off-market share buybacks including implications for different types of shareholders, compliance and administrative costs, the basis for determining the capital and dividend components of the proceeds and the application of dividend streaming rules.

3.2 The Discussion Paper proposed that these issues be assessed against a policy framework that considers the efficiency, equity and simplicity outcomes of the current approaches and options to change the current approaches.

Efficiency

3.3 The current taxation treatment of off-market share buybacks comes at a cost to revenue. A key issue for the review was whether the efficiency benefits claimed from off-market share buybacks are sufficient to justify these costs; in particular, whether there are broader, economy-wide benefits from off-market share buybacks.

3.4 A large number of submissions to the review argued that off-market share buybacks are an efficient way for companies to return surplus cash to shareholders. For example, the Corporate Tax Association argued that:

> Buybacks are flexible as to the amount involved, they can be executed relatively quickly, they distribute surplus franking credits to shareholders and deliver value to non-participating shareholders through the discount linked improvement in EPS. This is quite apart from the positive market signal associated with company management acting on its conviction that the company's shares are cheaply priced.

3.5 The ASX also argued that there are economy-wide benefits from off-market share buybacks:

> The ability of companies to raise capital efficiently and cheaply is critical to Australia's economic well being. It is equally as important that companies have an efficient and cost effective means to return excess capital to shareholders if capital is to be optimally allocated across the economy. Companies that determine that they have excess capital that they cannot deploy productively should be able to return that capital to investors who can then reinvest it elsewhere.

3.6 Submissions also argued the importance of retaining off-market share buybacks as an option for capital management. The Australian Financial Management Association noted that as an efficient means of returning capital, off-market share buybacks are 'a significant feature of the equity market, which enhances the options available to investors in making their allocation decisions'. By allowing shareholders a choice about whether to participate, shareholders can have more control over the effect of the distribution of excess cash on the extent of their shareholding.

3.7 Analysis presented in the Discussion Paper supported the argument that off-market share buybacks are used to return surplus cash to shareholders. This can have economy-wide benefits by allowing shareholders to use this cash in more productive ways than retaining it in the company. The Board's analysis found that off-market share buybacks provide a mechanism for companies to generate positive returns through distributing excess cash when investment opportunities are declining.

3.8 The Board considers that off-market share buybacks add to the efficiency of the capital markets and so have broader economy-wide benefits. The Board finds that they should continue to be available to companies as a capital management tool. The recommendations that have been made by the Board are therefore designed to retain off-market share buybacks as a viable option for companies to return capital to shareholders.

3.9 One of the terms of reference of this review asked the Board to take into account the application of the dividend streaming rules to off-market share buybacks.

3.10 An issue before the Board was whether concerns about unequal distribution of franking credits still have currency in a tax system that has evolved to provide refundable imputation credits to some taxpayers.

3.11 The basis for the claim that excessive streaming of dividends arises in off-market share buybacks results from the deemed capital component being significantly lower for taxation purposes than the market value of the share. This leads to a relatively high dividend component compared to the capital component. Consequently, lower rate taxpayers are able to receive refundable franking credits as well as generally benefiting from the availability of a notional loss, whereas the top-up tax paid by high-rate individual taxpayers who receive franked dividends discourages them from participating as they would receive a greater return by selling on-market and utilising the availability of the CGT discount for shares held for more than 12 months.

3.12 Offering shareholders a choice to participate was argued in some submissions to be a benefit because franking credits can be distributed optimally, that is, to those who most value them. The Discussion Paper noted that off-market share buybacks can enable companies to distribute franking credits to those shareholders who are best able to use them and avoid them being wasted on shareholders for whom franking credits are not as valued.

3.13 Under an off-market share buyback the wastage of franking credits is limited because shareholders who will benefit most will participate in the buyback (for example shareholders who have low tax rates and access to refundable tax credits) and those who stand to benefit less (for example, higher rate shareholders and non-residents) will not participate. Limiting participation to those who benefit most from franking credits facilitates the buyback operating at a discount to the market price as the participating shareholders use the franking credits as compensation for the discount.

3.14 A view was submitted that the greater benefits obtained by tax exempt and low-rate taxpayers in off-market share buybacks are a result of the design of the tax system, including progressive individual tax rates, an imputation system that provides for refundable tax offsets and the CGT discount. For example, the ASX noted that:

> There has been criticism from some quarters around the fairness of the existing arrangements applying to off-market buybacks, as some shareholders are more likely to benefit from the structure of these buybacks (small capital return and a large fully franked dividend) than others. However, this is also true of any choice of capital management option given the nature of our tax system and the different tax position, and hence capital/income preferences, of individual shareholders. Achieving equivalent post-tax treatment across different shareholders is not a realistic objective for any particular management option.

3.15 Ernst & Young also argued that any streaming was the result of an appropriate application of the law, noting that: 'off-market share buybacks represent merely a commercial application of the dividend imputation system in respect of a particular capital management technique'. It went on to argue that:

> … Parliamentary intent is clear that Australian resident low taxed and tax exempt shareholders do not have wastage of their entitlements to franking benefits.

3.16 Some submissions argued that limiting the wastage of franking credits was appropriate as it allowed the shares to be brought at a discount. This meant that companies could distribute cash in a way that leads to improvements in earnings per share (EPS), which is of benefit to all continuing shareholders through a positive impact on the share price. Other methods of returning surplus cash do not impact positively on the share price in this way.

3.17 The Board considers that against the background of the current taxation system, the policy underlying the taxation treatment of off-market share buybacks that seeks to limit the unequal distribution of franking credits should be modified to reflect the overall policy of the tax system.

EQUITY

3.18 Another of the terms of reference for the review asked the Board to consider 'the implications of the current taxation treatment of off-market share buybacks for different types of shareholders'.

3.19 The streaming of dividends to those shareholders who can most benefit from them has been criticised as inequitable as some shareholders benefit more than others. Taxpayers Australia submitted that:

> … dividend streaming of franking credits to select shareholders is inconsistent with the general principles that have been established to ensure that tax paid on behalf of shareholders is to be shared equally amongst all shareholders in proportion to their shareholdings.

3.20 Another argument is that participating shareholders benefit while non-participating shareholders do not. As discussed above, participating shareholders are compensated for the discount through access to franked dividends. The issue is whether, and to what extent, non-participating shareholders are also compensated.

3.21 The Board discussed this issue at some length in the Discussion Paper. It noted that the extent to which non-participating shareholders are compensated for the discount depends upon the market valuation of the undistributed franking credits. This in turn depends on whether they would otherwise have been distributed to shareholders through dividends. If the franking credits would have been distributed to shareholders along with dividends, now or in the future, the off-market share buyback benefits participating shareholders at the expense of non-participating shareholders by limiting the future flow of franked dividends. In the Discussion Paper it was noted that the available evidence for Australia suggests that off-market share buybacks are not being used as a substitute for ordinary dividends and so are not limiting future dividend payouts. There is empirical evidence that the market reacts positively to the announcement of an off-market share buyback. This could suggest that collectively shareholders are better off, while the distribution of benefits could still be uneven.

3.22 A number of submissions made to the review argued that non-participating shareholders benefit through improvements in the share performance of the company. The Corporate Tax Association noted that:

> Non-participating shareholders benefit from buybacks because the discount below market price at which the shares are bought back by the company creates an EPS benefit which, according to UBS research, is sustained and is superior to alternative methods of returning surplus funds.
>
> There is also positive signalling associated with these transactions which, all things being equal, will benefit non-participating shareholders through a stronger share price performance.

3.23 However, CPA Australia argued that the impact on non-participating shareholders was unclear.

> The actual outcome depends on the value attached to franking credits and there does not appear to be any conclusive view on this, although it appears to turn in large part on whether they would otherwise have been distributed to shareholders with dividends either now or in the future. … it is still uncertain whether non-participating shareholders benefit from an off-market share buyback (which would be by way of an increased EPS and/or an increase in the value of the company's shares after the buyback) unless the company concerned seeks to specifically address this issue.

3.24 Another equity issue that was raised in relation to off-market share buybacks is the ability to purchase shares in the company after the announcement of the buyback. As outlined in Chapter 2, taxation laws and ASX rules require that there be 45 clear days between the date an investor enters into a contract to purchase shares and the date of acceptance of tenders to participate in the buyback and get the benefits of the franking credit. Where the timetable for the buyback allows more than 45 days, shares can be purchased after the announcement of the buyback and be eligible to receive the benefits.

3.25 Analysis in the Discussion Paper pointed to evidence of positive abnormal returns just after an announcement and negative abnormal returns a few days later. Abnormal trading in those days may lead to temporary price distortions. The paper also reported evidence of anticipatory purchase of shares in companies that are likely to conduct, or have indicated they are considering, a buyback.

3.26 The Discussion Paper also noted that purchasing shares post-announcement is not a riskless strategy as there is no guarantee that all shares tendered will be bought back. However, post-announcement trading can also provide greater incentive, as well as opportunity, for tax exempt and low-tax rate shareholders. An effective floor on the level of discount provided by the guarantee of the cap on the discount can amount for these taxpayers to an effective guarantee that tenders at particular discounts will be accepted, reducing the risk of purchasing shares in order to participate in the buyback.

3.27 Submissions generally argued against any restriction on post-announcement trading. The Corporate Tax Association argued that:[15]

> Subject to the 45-day rule, we believe that investors should be able to acquire shares in the period following the announcement. We note there is often a significant spike in volume well before the actual announcement, attributable to the company's preceding signalling that it is considering a buyback. This is inevitable under a two stage announcement process.

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15 The 45 day rule limits streaming in imputation credits by ensuring that a shareholder who benefits from the imputation credits has held the share at risk for 45 days for ordinary shares and 90 days for preference shares. This rule is discussed in paragraphs 2.17 to 2.20.

3.28 Similarly, PricewaterhouseCooper argued that:

> … where shareholders participating in an off-market share buyback have satisfied the 45 day rule there does not seem to be any policy reason for denying the benefit of franking to investors. Indeed, other market transactions exist where similar market behaviour is exhibited by investors, most notable in the case of "special dividend" announcements. As such, imposing some additional or different condition to qualify for franking credits in the context of off-market share buybacks would not seem to be based in principle and would operate to ignore the commercial risks an investor is exposed to in these circumstances.

3.29 The ASX noted that restricting post-announcement trading:

> … seems to be a particularly punitive outcome for investors who buy shares in the few days leading up to the announcement. Shares could be purchased prior to the announcement by investors at a price reflecting a number of factors, including the markets view on the possibility of a buyback or other capital management action but then the investor is denied the opportunity to benefit from the franking credits attached to the shares.

3.30 Ernst & Young sought greater clarity in any policy concerning restrictions on post-announcement trading:

> In relation to post-announcement trading in companies which have announced off-market share buybacks, the policy analysis must consider the liquidity created from this feature.

3.31 The Board was mindful of the equity concerns raised by the current treatment of off-market share buybacks during its deliberations. The Board's recommendations seek to retain the efficiency benefits of off-market share buybacks while ensuring that non-participating shareholders receive some of the benefits from the off-market share buyback and that the incentives to jump in and obtain a risk-free benefit are curtailed.

SIMPLICITY

3.32 The terms of reference for the review require the Board to consider the compliance cost impacts of off-market share buybacks and the administrative practices of the ATO.

3.33 The current taxation provisions applying to off-market share buybacks are, as noted in the Discussion Paper, resource-intensive for the company and the ATO.

3.34 Chapter 2 discussed the need for the companies initiating the off-market share buyback to, in most cases, obtain a private ruling as well as relying on public rulings. This is because the method for determining the capital/dividend split and the

allowable level of discount are not specified in the law. A proposed off-market share buyback is also examined against the anti-avoidance rules.

3.35 The final price of the buyback will not be known until the buyback is complete. As a result the final tax outcome is not known so a final ATO ruling may only be available after the buyback is complete.

3.36 It has been noted in submissions that it is costly to obtain valuations for unlisted companies and difficult to obtain agreement from the ATO on the value of the shares. For example, the Taxation Institute of Australia noted that:

> … the valuation of shares in an unlisted company that undertakes an off-market share buyback 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.

3.37 There was support for a 'safe harbour' to improve certainty and to enable easier and quicker compliance. PricewaterhouseCoopers noted that:

> … notwithstanding PS LA 2007/9 it remains necessary for a ruling process to be put to the ATO which may involve lengthy turn around times.

3.38 There was a concern that the ATO might not rule on anti-avoidance provisions in some cases. The Institute of Chartered Accountants noted 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 …

3.39 The Board also received submissions on whether the 'safe harbour' rules should be included in the legislation, which results in more certainty, or alternatively in binding administrative advice from the ATO, which may be more flexible. Ernst & Young argued that:

> 'Selective legislative changes might allow the mechanisms to operate more efficiently. However it is critical that these modifications allow significant flexibility for companies and their shareholders, rather than introducing a prescriptive mechanical outcome for off-market share buybacks, which will not meet all circumstances.

3.40 Concerns were also raised about the general application of the anti-avoidance provisions. Professor Richard Vann made the following input to the review:

> The general application of Part IVA clearly is intended to have moral overtones in judging the conduct of taxpayers. Yet the ATO routinely applies the provision in class rulings for off-market share buybacks. This is likely to send very confusing signals to the taxpaying population at large and dilutes the deterrent effect of Part IVA.

The above view is supported by Ernst & Young:

> We submit that the legislative reform should include, at minimum, moving certain relevant rules from section 177EA, which is part of Part IVA, the general anti-avoidance regime. It is inappropriate for the ATO to administer Government policy by using the anti-avoidance rules. The rules should be in the tax law relating to the simplified imputation system.

3.41 The Board accepts that compliance and administrative costs involved in determining the appropriate taxation treatment of off-market share buybacks are unnecessarily high and should be addressed. The set of recommendations the Board has made will ease these costs.

Chapter 4: Findings and recommendations

4.1 Chapter 3 discussed the issues that the Board has considered in reviewing the taxation treatment of off-market share buybacks. The Board's conclusion is that off-market share buybacks have an important role as a capital management tool in the Australian market. The Board recommends that changes should be made to the taxation arrangements to further enhance their economic efficiency and to reduce the current high compliance costs of taxpayers and high administrative costs of the ATO.

4.2 A number of equity concerns were raised in relation to the occurrence of unequal distribution of franked dividends in off-market share buybacks, including that this amounted to subsidisation of low-tax rate and tax exempt shareholders by higher tax rate shareholders and the broader tax paying community. However, it should also be noted that higher tax rate shareholders get more absolute benefit from the CGT discount compared to tax exempt and lower rate shareholders. The Board considers that the unequal distribution of franked dividends arises from deliberate design features of the taxation system — the refundability of franking credits, differences in marginal tax rates and the CGT discount — rather than the off-market share buyback provisions themselves.

4.3 Significant compliance cost savings could be made by changing some of the taxation provisions currently applying to off-market share buybacks. In particular, the Board recommends removing the cap on the discount and denying the ability to claim notional losses to all shareholders who participate in off-market share buybacks conducted by listed companies.

4.4 The interaction of these two recommendations will determine their impact on the attractiveness of off-market share buybacks to shareholders and to companies conducting the buyback. While allowing the market to determine the value of the discount has the potential to lead to a discount that is higher than the cap, making participation more attractive to tax exempt and low-tax shareholders, denying notional losses will reduce the return for shareholders other than tax exempts, and so may act as a brake on the extent of the discount. The level of the discount will in turn influence the extent to which benefits flow to non-participating shareholders and decisions about whether to engage in post-announcement trading.

4.5 The Board also recommends that some other aspects of off-market share buybacks which currently require a taxation ruling be specified in legislation or by the general public ruling process (so that individual rulings are not routinely required for off-market share buybacks by listed companies). The Board also recommends that in

amending any existing provisions that apply to off-market share buybacks, consideration be given to moving the provisions currently in the ITAA 1936 to the ITAA 1997.

CAP ON LEVEL OF DISCOUNT

Background

4.6 Tender-style off-market share buybacks conducted by listed companies are now usually conducted at a discount to the price on the ASX. The discount is facilitated by the current taxation arrangements that allow shareholders to receive a franked dividend as part of the consideration for the buyback, compensating them for participating in the buyback at below the price on the ASX.

4.7 As the size of the discount grows, the greater is the likelihood that participation in the buyback will be attractive to those shareholders for whom the tax benefits of receiving franked dividends are greatest, namely tax exempt shareholders or those with a lower marginal tax rate and who can benefit from refundable imputation credits, such as charities and superannuation funds.

4.8 However, there are a number of anti-avoidance provisions that apply to the taxation treatment of off-market share buybacks that seek to limit the extent to which franked dividends are streamed to some shareholders. These are discussed at some length in the Discussion Paper. In particular, section 177EA of the ITAA 1936 applies where there is a disposition of shares or interests in shares and a franked dividend is paid to a person where it could be concluded that a person entered into a scheme for the purpose of obtaining an imputation benefit. An imputation benefit arises where a person is entitled to a franking credit or a credit would arise in a company's franking credit account.

4.9 If certain conditions are met, section 177EA gives the Commissioner discretion to either debit the franking account of the company distributing franking credits or deny the recipient of the imputation credits the usage of the imputation credits. The effect of debiting an amount to the franking credit account of the company conducting the buyback is to compensate the revenue for avoided wastage or streaming of franked dividends, particularly in relation to non-resident shareholders. This is in recognition of the fact that under an off-market share buyback, dividends are being paid in a manner that does not accord with shareholding patterns.

4.10 The Commissioner will exercise the discretion if having regard to the relevant circumstances such a scheme was undertaken for the purpose of enabling taxpayers to obtain an imputation credit. This provision is consistent with the intention when imputation was first introduced that there would be imputation credit wastage. In considering how to exercise his discretion the Commissioner takes account of the proposed maximum discount level/minimum buyback price in any off-market share

buyback arrangement. Companies conducting off-market share buybacks uniformly request that, where section 177EA applies, there be a debit to their franking account rather than denial of imputation benefits to resident shareholders.

4.11 Presently, the maximum level of discount acceptable to the ATO in a tender process buyback is 14 per cent calculated by reference to the VWAP per share of the shares for the five days up to and including the closing date of the buyback.

4.12 In determining that 14 per cent is an acceptable level of discount, the ATO considered the flow of dividends in off-market share buybacks compared to shareholding patterns. The ATO considers that streaming of franking credits routinely occurs in an off-market share buyback. For example, there is clear evidence of over-participation by superannuation funds and zero-rate taxpayers in off-market share buybacks generally.

4.13 The ATO accepts that some routine level of streaming may occur up to that 14 per cent level, but generally expects that the buyback should still remain attractive to a broader range of taxpayers. Where a discount level of greater than 14 per cent is proposed, the attractiveness of an off-market share buyback diminishes for all but zero-rate and 15 per cent taxpayers, mainly superannuation funds.

Findings

4.14 The imposition of a 14 per cent cap on the discount raised a number of issues for the Board.

4.15 The effect of the cap is to set the discount in a tender-style off-market share buyback at a rate other than the level that would be determined by the market. However, there are benefits to be gained from allowing the market to set the size of the discount. The tender process means that there is trade between low- and high-rate shareholders of franked dividends/capital losses (which are traded from high- to low-rate shareholders) and capital gains (which are traded from low- to high-rate shareholders). This results in a gain from trade as both sets of shareholders are made better off. Allowing those buybacks that are of mutual benefit to shareholders to proceed will improve the efficiency of buybacks and their contribution as a capital management arrangement open to companies.

4.16 In most off-market share buybacks, the offer by the company to buy back its shares is over-subscribed. This suggests that the discount may be operating to limit participation in buybacks and hence companies' access to a capital management tool. Table 5.1 in the Discussion Paper notes that the scale-back percentages (that is, the percentage of offers that were not accepted) of off-market share buybacks undertaken between November 1997 and March 2007 ranged from zero to nearly 95 per cent.

4.17 By limiting the level of the discount below the market clearing rate, the cap also limits the benefits to non-participating shareholders. Shareholders who do not

participate in the off-market share buyback may benefit from an increase in the value of the share. This could be driven by an increase in EPS, as there are fewer shares on issue after an off-market share buyback. If the market clearing rate is allowed the discount is expected to increase, and non-participating shareholders may benefit more from the off-market share buyback. However, as outlined in paragraph 4.4 the level of a market-determined discount rate may be impacted by the denial of notional losses for some participating shareholders.

4.18 The cap can also impose high compliance costs on companies undertaking an off-market share buyback. Detailed calculations are performed to determine the minimum acceptable share price the company can offer to shareholders who want to participate in the off-market share buyback. As the application of the anti-avoidance provisions rests on the Commissioner's discretion, companies seek to obtain a ruling from the ATO to obtain agreement on an acceptable discount.

4.19 The cap also exacerbates the issue of post-announcement trading. When an off-market share buyback is announced, investors have a few days to purchase shares and still benefit from the imputation credits while complying with the requirement that shareholders hold the shares at risk for 45 days in order to be able to benefit from the imputation credits.

4.20 For low-rate and tax exempt shareholders the effective floor on the discount provided by the cap can mean that they can buy into the company after the buyback has been announced and participate in the tender with an effective guarantee that their bids will be accepted. That is, there is reduced risk to them from acquiring shares in the company after the announcement of the buyback, increasing their incentive to do so.

Benefits of removing the cap

4.21 The issues raised by the cap could be addressed by allowing the market to determine the value of the discount. The Board considers that this approach brings with it significant improvements.

- Efficiency would be improved through maximising companies' access to the capital management benefits of buybacks.
- The benefits to non-participating shareholders may increase if the value of the discount is higher, so that non-participating shareholders benefit through a higher share price. When the remaining shareholders do sell their shares they may realise a capital gain. However, as noted in paragraph 4.4, the recommendations in this Report need to be considered together to determine whether and to what extent they will result in the level of the discount being higher than the cap.
- Incentives for post-announcement trading may decrease as some investors are no longer guaranteed a minimum share price, as the market will now determine the

share price the company undertaking the off-market share buyback will accept. As a result post-announcement shareholders will no longer to be able to accurately determine their return from buying into a buyback, which may increase their risk. In addition there is the risk to the investor that their bid is not accepted by the company undertaking an off-market share buyback and that they will need to retain the shares or sell them on-market.

- Administration costs would be reduced as companies would no longer be required to apply for a taxation ruling about the discount that would be acceptable to the ATO. For similar reasons, compliance costs would be reduced for companies undertaking buybacks.

Costs of removing the cap

4.22 However, as removing the cap on the discount may result in a larger discount, the effect may be to stream more franked dividends to low-rate and tax exempt shareholders at a cost to taxation revenue. This is contrary to the current application of the anti-avoidance provisions that apply to off-market share buybacks.

4.23 However, the benefits that participating and non-participating shareholders seek to trade in a tender-style off-market share buyback are benefits that are legitimately available under the general taxation provisions. The progressive marginal personal income tax rates applied to individuals, the exemption of some entities from income tax, the taxation treatment of superannuation funds, the availability of refundable franking credits and the discount available on capital gains are all features of the current taxation regime. When this regime is applied to a tender-style off-market share buyback it generates a flow of taxation benefits to certain shareholders that are not available to others.

4.24 The Board considers that if the discount is a result of shareholders of a listed, widely held company freely trading their shares on the market at arm’s length, this process should not amount to a scheme to achieve an imputation benefit or streaming of imputation benefits (other than for non-resident shareholders as discussed below). Therefore, the anti-avoidance provisions in section 177EA and section 204-30 should not apply.

4.25 The Board recognises there may be circumstances where section 177EA or section 204-30 may apply, such as in the case of a tightly held listed company undertaking an off-market share buyback and the majority shareholder determining the most suitable buyback price that benefits the majority shareholder. This situation may result in a buyback price that has not been determined by the market or by parties dealing at arm’s length.

Recommendation 1

The Board recommends that there should be no cap on the level of the discount to an Australian securities exchange value of shares under off-market share buybacks conducted by listed companies.

NON-RESIDENT TO RESIDENT STREAMING

Findings

4.26 Arguments were put to the Board that the debiting of franking accounts to take account of non-resident shareholders is inappropriate. For example, the Australian Foundation Investment Company argued that 'it is a misappropriation by the government of a company's, and therefore shareholder's, assets'.

4.27 However, unlike the case of resident-to-resident streaming, there is a clear case for arguing that current Government policy is to allow wastage of franking credits to non-residents. The Board accepts that the current approach to non-resident to resident streaming is appropriate to protect the Australian tax base, in which the corporate tax in part operates as the Australian tax levy on non-resident investors for the benefits obtained from investing in Australia.

4.28 The Board also accepts that the anti-avoidance provisions are an inappropriate vehicle to achieve this outcome. They impose compliance and administrative costs on taxpayers and the ATO and may raise understandable concerns among taxpayers about being subject to anti-avoidance provisions.

4.29 A purpose-built provision would ease compliance costs. However, the anti-avoidance provisions would continue to apply as appropriate.

Recommendation 2

The Board recommends that:

- there should continue to be a debit to the franking account of the company to reflect the intended wastage of franking credits in the hands of non-resident shareholders; and
- there should be a specific provision dealing with this issue in the context of off-market share buybacks rather than relying on the general streaming and integrity provisions. That provision should include the formula for calculation of the debit to the franking account. Franking credits will continue to be available to shareholders notwithstanding this debit to the franking account.

NOTIONAL LOSSES

Background

4.30 Under the current taxation provisions applying to off-market share buybacks, the deemed capital component of the buyback price is the amount per share that is debited against the company's share capital account. The deemed dividend component is the difference between this deemed capital component and the buyback price.

4.31 This approach is similar in some respects to the 'slice' approach discussed in *A Tax System Redesigned* (the Review of Business Tax). Under that approach, a distribution that arises from the cancellation of a membership interest, such as a buyback, will be treated as coming from the contributed capital, taxed profits and untaxed profits attributable to the cancelled membership interest. This means that the capital component of a distribution may differ from the capital actually contributed by the member. However, the review commented that the slice approach reflects the 'substance of what is happening' because the purchase of a membership interest is a purchase of a right to the capital and accumulated and future profits of the company.[16]

4.32 There are a number of ways in which this can be given practical effect. While the capital/dividend split can be nominated by the company, the ATO in its Practice Statement PS LA 2007/9 suggests that the average capital per share is the preferred methodology for determining the capital/dividend split. The Practice Statement also suggests several other methodologies that may be acceptable depending on the company's circumstances.

4.33 In most instances, the amount the shareholder actually paid for the share is generally greater than the deemed capital portion calculated in the capital/dividend allocation. Consequently these shareholders are treated as having a capital loss which they are able to offset against capital gains made on the disposal of other assets (and which may be subject to a CGT discount). In one sense the loss is notional as the buyback price including the dividend may be greater than the initial purchase price of the share.

4.34 The Review of Business Tax also considered the appropriateness of a taxation treatment that gave rise to a notional loss. It noted that, without the loss, there was a potential for double taxation because the entity's retained profits may have been taxed and the sale of the share gives rise to a realisation (or capital) gain. The loss that arises through the slice approach offsets the capital gain and so ensures that there is no double taxation.[17] That review's discussion paper[18] noted that the potential for double

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16 Review of Business Taxation, chaired by Mr John Ralph, 1999, *A Tax System Redesigned: More Certain, Equitable and Durable*, AGPS, Canberra. Page 454

17 Review of Business Taxation, chaired by Mr John Ralph, 1999, *A Tax System Redesigned: More Certain, Equitable and Durable*, AGPS, Canberra. Page 455

taxation does not occur with off-market share buybacks as the company buying back the shares determines the source of funds.

4.35 However, the Board notes that non-resident shareholders (who indirectly participate in buybacks conducted by listed companies by selling their shares to resident shareholders who directly participate in the buyback) do not generally pay CGT when they then sell their shares. Consequently, if they sell to a resident who then incurs a notional loss by participating in an off-market share buyback, this will result in a cost to revenue as there is no CGT gain to offset the notional loss. Similarly, it is unlikely that resident sellers have been fully taxed on sales as pre-CGT shareholders are not taxed on sale and individual, trustee and complying superannuation entity shareholders are entitled to the CGT discount for shares held more than 12 months.

4.36 Under the current taxation approach, the deemed capital component received by a shareholder is adjusted to take account of the market value of the share at the time of the buyback as if the buyback did not occur and was never proposed to occur — the market value uplift rule.[19] This rule and its application are outlined in paragraphs 2.12 and 2.13. The object of this rule is to exclude the distortionary effect of the buyback on the share's value for taxation purposes.

4.37 The amount of the market value uplift cannot be calculated until the buyback price has been determined, which, under a tender-style buyback, will not be until the buyback has actually closed. The formula to be used for calculating the market value of shares in an ASX-listed company is set out in TD 2004/22. However, companies can approach the ATO to request a variation if they consider an alternative formula gives a more accurate reflection of the market value.

4.38 At present a shareholder that is a company is entitled to a capital loss in the context of an off-market share buyback only if the total proceeds under the buyback are less than the company's reduced cost base for those shares. Similarly, if the shares are held on revenue account, the company is entitled to a revenue loss only if the total proceeds are less than the original cost of those shares.

4.39 Ideally, it would be appropriate to allow the notional loss in those cases where it is necessary to prevent double taxation of corporate income and deny it in those cases where there is no double taxation. However, such a system would be extremely difficult to design and would be very complex to apply. It is therefore necessary in practice to provide the same treatment in all cases.

4.40 The Board also noted that there are a number of other circumstances where companies' shares are cancelled in the same way as off-market share buybacks, including capital reductions involving share cancellations and liquidations. At present

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18 Review of Business Taxation, chaired by Mr John Ralph, 1999, *A Platform for Consultation* AGPS, Canberra. Page 453.

19 ITAA 1936, subsection 159GZZZQ(2).

in those cases shareholders are not entitled to notional losses. It would seem appropriate to align the taxation treatment of transactions that achieve similar outcomes.

Findings considered

4.41 The Board considered two key questions in relation to these notional losses:

- Is average capital per share an equitable methodology for determining the capital/dividend split and hence the notional loss?
- Should participants in buybacks have the ability to utilise notional losses when they have an actual economic gain?

4.42 Relying on the average capital per share to determine the notional capital/ dividend split raised some equity concerns for the Board. The actual price at which past or present shareholders contribute to the share capital of the company plays no part in determining the split of their return into capital and dividends. As a result, shareholders may make a notional loss in situations where, had the full sale price been regarded as capital, they would have made a capital gain. Low- or zero-rate shareholders who are able to receive franked dividends and refundable imputation credits may even be better off than if they sold the shares on market to a third party.

4.43 The Board considered two alternatives methodologies for determining the capital/dividend split to see if they could address the equity concerns raised.

4.44 The capital/dividend split could be determined on the basis of the shareholder's actual entry cost per share. This approach would address the equity issue as no participating shareholder would receive a capital loss or a capital gain. However, the company would be required to obtain or maintain this information in order to determine the distribution of franked dividends. While this information generally would be readily available for unlisted companies, the same could not be said for listed companies.

4.45 An alternative is to base the capital/dividend split on the basis of the average entry cost per share for each shareholder. However, this would pose the same difficulties for companies in determining this information. Relying on average entry cost per share inevitably means that the average will be too high for some shareholders and too low for others, which would not adequately address the equity for many shareholders. The Board concluded that either of these methodologies may therefore increase complexity and compliance costs.

4.46 On balance, the Board considers that average capital per share is the most reliable measure that can be used to determine the share capital utilised in the buyback and the one most consistent with policy in setting the amount of the dividend in the buyback. However, as mentioned in paragraph 4.35, because it will often be the case that former

shareholders have not been fully taxed on the profits derived by the company while they were shareholders, the Board considers that concerns around the calculation of a loss which excludes the dividend from the calculation have some basis.

4.47 Consequently the Board considers that in the case of buybacks by listed companies, it will be simpler and easier for shareholder compliance if there is a clear rule which disallows notional losses (except where the relevant cost or cost base of the shareholder in the shares exceeds the total amount received by the shareholder in the buyback). It is also consistent with current law in other areas, including the treatment of Australian companies which participate in buybacks and the position in liquidations and other cancellations of shares. This approach may also have a positive impact on taxation revenue countering the negative impact that may arise from removing the cap on the discount.

4.48 When viewed in combination with the other recommendations, the Board considers the outcome to be a balanced package. The removal of the cap on the discount and the removal of the current application of the market value uplift rule will eliminate many compliance and administrative costs currently incurred in off-market share buybacks by listed companies. On the other hand the removal of the cap on the discount may mean that the current level of discount will rise and that buybacks will be more concentrated among tax exempt and low-rate taxpayers, giving rise to concerns about the unequal distribution of imputation credits. As the Board has noted previously, it considers that this is an outcome of structural elements of the tax system rather than share buybacks. Streaming concerns should not be allowed to prevent the operation of the market forces in this context.

4.49 The Board notes that denying shareholders the ability to claim notional losses arising from their participation in an off-market share buyback conducted by a listed company will reduce the returns for some participating shareholders (other than tax exempts). This will reduce the incentive for shareholders, other than tax exempts, to engage in post-announcement trading to obtain a risk-free benefit. Notwithstanding the reduced shareholder returns, the Board expects that off-market share buybacks will continue to be attractive to listed companies and their shareholders. Denying notional losses to all shareholders would also achieve comparable treatment between companies and other entities participating in off-market share buybacks (as outlined in paragraph 4.38) as well as being consistent with the taxation treatment of notional losses in relation to other capital reductions. The Board also expects that denying the ability to claim notional losses and the consequential removal of the need for the application of the market value uplift rule will result in a significant reduction in the complexity and compliance costs associated with off-market share buybacks.

4.50 The Board also considered whether notional losses should be denied to shareholders participating in buybacks conducted by unlisted companies. The Board noted that as shares in unlisted companies are normally not widely traded, the actual entry cost for each shareholder could be determined or estimated with a reasonable

degree of accuracy. In these circumstances the capital dividend split is more likely to accord with the slice approach as set out in paragraph 4.31 and, as set out in paragraph 4.34, there is a greater potential for double taxation because the entity's retained profits may have been taxed. Consequently, the Board considers that there is a case for allowing shareholders (including companies) that participate in off-market share buybacks conducted by unlisted companies to utilise any notional losses to offset this potential for double taxation.

Recommendation 3

The Board recommends that:

- notional losses should be denied to all shareholders who participate in off-market share buybacks conducted by listed companies. The market value uplift rule in subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* should not apply to off-market share buybacks conducted by listed companies; and

- notional losses should be allowed for all shareholders who participate in off-market share buybacks conducted by unlisted companies. The market value uplift rule in subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* will continue to apply to off-market share buybacks conducted by unlisted companies.

GREATER CERTAINTY

Findings

4.51 The Board considers that compliance costs for taxpayers and the administrative costs for the ATO are overly resource-intensive. The process is also not able to deliver a certain taxation outcome for the company before the buyback is complete. This creates uncertainty for the company and its shareholders.

4.52 The regular application of the anti-avoidance rules to each buyback adds to the complexity and may unnecessarily concern taxpayers.

4.53 There were many calls to the review to provide greater certainty. The Board considers that in conjunction with the previous three recommendations, the complexity and compliance costs associated with off-market share buybacks would be reduced if various other aspects of off-market share buybacks (for which private rulings are currently sought) were prescribed in legislation or by the public ruling process (whichever appropriate). This would not, of course, preclude a company whose arrangements fall outside the rules from applying for specific rulings.

Recommendation 4

The Board recommends:

- legislative provisions be introduced that:
  - outline the methodology for the capital/dividend split. Average capital per share should be specified as the general method to be used by companies, with a discretion available to the Commissioner of Taxation to allow companies to apply another methodology such as the slice method or the embedded value method when appropriate to their particular circumstances. The ATO should provide guidance on the circumstances in which these other methodologies may be appropriate;
  - specify an extension of time for listed companies conducting an off-market share buyback to provide a distribution statement; and
  - confirm that sections 45A and 45B and paragraph 177EA(5)(b) of the *Income Tax Assessment Act 1936*, and section 204-30 of the *Income Tax Assessment Act 1997*, will not be applied to tender-style off-market share buybacks conducted by listed companies where average capital per share is used to determine the capital/dividend split;
- taxation rulings be issued that:
  - outline the appropriate buyback timetable; and
  - outline the application of the 45 day rule, including how LIFO (last in first out) applies in relation to off-market share buybacks conducted by listed companies.

UNLISTED COMPANIES

Findings

4.54 Unlisted companies are currently treated in the same way as listed companies with regard to off-market share buybacks. The only difference is that unlisted companies are required to perform a valuation as the share price cannot be determined from the ASX.

4.55 The Board's view is that unlisted companies, in most instances, should be treated the same as listed companies. However, they should be treated differently with respect to:

- calculating the value of the shares; and

- allowing the notional loss to prevent double taxation as their shares are not widely traded. This issue is addressed in Recommendation 3.

Recommendation 5

The Board recommends the off-market share buyback provisions should generally apply in the same way to listed and unlisted companies subject to the following modifications:

- sections 45A and 45B and paragraph 177EA(5)(b) of the *Income Tax Assessment Act 1936*, and section 204-30 of the *Income Tax Assessment Act 1997*, will continue to apply to off-market share buybacks conducted by unlisted companies; and
- the ATO should continue to provide guidance on market valuation for unlisted companies.

INCLUDE BUYBACK PROVISIONS IN THE *INCOME TAX ASSESSMENT ACT 1997*

Recommendation 6

The Board recommends that in amending any existing provisions that apply to off-market share buybacks, consideration be given to moving the provisions currently in the *Income Tax Assessment Act 1936* to the *Income Tax Assessment Act 1997*.

APPENDIX A: CONSULTATION FORUMS

SYDNEY, 26 JULY 2007

Name:	Organisation:
Aitken, J N	
Ali Noroozi	Institute of Chartered Accountants
Capito, Alf	Ernst & Young
Capodistrias, Peter	Minter Ellison Lawyers
Chang, Ernest	Greenwoods & Freehills
Chang, Vivian	Blake Dawson Waldron Lawyers
Chigwin, Colin	Pitcher Partners
Creecy, Greg	Lend Lease Corporation
Crowley, Emma	Ernst & Young
Cunningham, Lance	PKF Australia Limited
Dirkis, Michael	Taxation Institute of Australia
Dowd, Paul	RBC Dexia Investor Services Trust
Elansary, Yasser	Australand Holdings Ltd
Frost, Tony	Greenwoods & Freehills
Gay, Bridget	
Gelski, Richard	Johnson Winter & Slattery
Gerber, Solomon	
Goldsmith, Mark	Gilbert & Tobin
Grant, Cameron	ATO
Griffin, Edward	
Hall, Martin	Lonergan Edwards
Hang, Denise	Australian Financial Markets Association
Heading, Brett	Board of Taxation
Hobourn, Gary	ASX Limited
Hooper, Paul	Lend Lease Corporation Ltd
Ispanovic, Steven	ATO
Jenner, Simon	Ernst & Young
Joice, Vernon	Board of Taxation Secretariat
MacInnes, Isabelle	Deloitte Touche Tohmatsu
Mayne, Eric	Board of Taxation
McCormack, Jock	Phillips Fox

Sydney, 26 July 2007 (continued)

Name:	Organisation:
McKenzie, Don	
McLoughlin, Andrew	Australian Financial Markets Association
Millett, Chris	Commonwealth Bank of Australia
Oner, Tim	Westpac
Paterson, John	
Payne, Karen	Law Council of Australia
Phin, Karen	UBS AG
Plummer, Wayne	PricewaterhouseCoopers
Regan, Tony	Treasury
Rendall, Curt	Board of Taxation
Renshaw, Belinda	UBS AG
Sidari, Anthony	ATO
Vanzella, Jacqui	Macquarie Bank
Vroombout, Sue	Board of Taxation Secretariat
Warburton, Dick	Board of Taxation
Whiteman, Steve	Cochlear Limited
Wong, Jenny	KPMG
Wong, Ka Sen	Clayton Utz
Wryell, Jan	ATO

MELBOURNE, 31 JULY 2007

Name:	Organisation:
Abbey, Paul	PricewaterhouseCoopers
Addison, Garry	CPA Australia
Anderson, Gina	Philanthropy Australia
Bourke, Peter	Deloitte Touche Tohmatsu
Bowen, Sam	Macquarie Bank
Brown, Christine	University of Melbourne
Carpenter, Stephen	KPMG
Chang, Vivian	Blake Dawson Waldron Lawyers
Clements, Andrew	Law Council of Australia
Coia, Enzo	Shaddick and Spence
Cummings, Ray	Pitcher Partners
Davis, Jill	The Finance and Treasury Association
Drenth, Frank	Corporate Tax Association
Dyson, Teresa	Blake Dawson Waldron
Edney, Ian	BHP Billiton
Emerson, John	Board of Taxation
Fabro, Allesandra	Business Council of Australia
Feltrin, Marco	The Association of Superannuation Funds of Australia Limited
Ferraro, Sam	Goldman Sachs JB Were
Franek, Petra	Telstra
Fry, Martin	Allens Arthur Robinson
Grant, Cameron	ATO
Greco, Tony	Taxpayers Australia Inc
Hodges, Hugh	ANZ Trustees
Ispanovic, Steven	ATO
James, Keith	Board of Taxation
Joice, Vernon	Board of Taxation Secretariat
King, Angela	Computershare
Kokkinos, Alexis	Deloitte Touche Tohmatsu
Kozaroski, Ilce	Ernst & Young
Lane, Brian	Ernst & Young
Lansell, John	
Liu, Michael	UBS
Marcus, Isaac	ATO
Marshall, Rod	Telstra
Matherson, Bruce	Rio Tinto
McBain, Bruce	Corporate Super Association
Menezes, Jeanelle	Allens, Arthur Robinson

MELBOURNE, 31 JULY 2007 (continued)

Name:	Organisation:
Mulqueen, Brendan	BHP Billiton
O'Loughlin, Frank	Law Council of Australia
Parker, Michael	Hall & Wilcox Lawyers
Paterson, John	
Phin, Karen	UBS AG
Porter, Andrew	Australian Foundation Investment Company
Potter, Michael	Australian Chamber of Commerce and Industry
Regan, Tony	Treasury
Schiavello, Anthonella	Minter Ellison
Schwarz, Brad	Australia and New Zealand Banking Group Limited
Sellars-Jones, Graham	
Shaddick, Richard	Shaddick and Spence
Sidari, Anthony	ATO
Thring, Gordon	Deloitte Touche Tohmatsu
Vanzella, Jacqui	Macquarie Bank
Ventura, Adam	ATO
Vroombout, Sue	Board of Taxation Secretariat
Wen, Stephanie	National Institute of Accountants
Wilkinson, Matthew	Computershare
Williamson, Sue	Taxation Institute of Australia
Win, Nu Nu	Treasury
Witherow, Philip	The Association of Superannuation Funds of Australia Limited
Wryell, Jan	ATO

APPENDIX B: SUBMISSIONS

Name/Organisation:	Received Date of Submission:
Aitken, J N	13 October 2006
Association of Superannuation Funds of Australia	27 August 2007
ASX Limited	29 August 2007
Australian Financial Markets Association	22 December 2006 30 August 2007
Australian Foundation Investment Company	11 May 2007 24 August 2007
Australian Shareholders' Association	24 August 2007
Business Council of Australia	31 August 2007
CARE Super Pty Ltd	3 September 2007
Corporate Tax Association	24 August 2007
CPA Australia	24 August 2007
Dixon Advisory	17 August 2007
Ernst & Young	24 August 2007
Griffin, E	23 August 2007
Group of 100, The	28 August 2007
HESTA Superannuation Fund	24 August 2007
Higgins Botha, Henry Botha	2 April 2007
Institute of Chartered Accountants in Australia	29 August 2007
Kendall, K	24 August 2007
Lord Mayor's Charitable Fund	4 September 2007
Mills, A W M	10 September 2007 11 September 2007 24 September 2007 27 September 2007
National Institute of Accountants	31 August 2007
O'Shannassy, B D	26 March 2007 17 August 2007
PricewaterhouseCoopers	27 August 2007
REST Superannuation	24 August 2007
Savas, A	3 November 2006

Submissions (continued)

Name/Organisation:	Received Date of Submission:
Sellars-Jones, G R	16 October 2006 16 February 2007 16 March 2007 11 May 2007 23 August 2007
Taxation Institute of Australia	27 August 2007
Taxpayers Australia	24 August 2007
Truscott, J B	13 August 2007
UBS AG	21 December 2006
Warakirri Asset Management	22 August 2007

In addition, eight confidential submissions were received.