Australian Government

The Board of Taxation

REVIEW OF THE TAXATION TREATMENT OF OFF-MARKET SHARE BUYBACKS

Discussion Paper

the board of taxation
www.taxboard.gov.au

The Board of Taxation
JULY 2007

Review of the Taxation Treatment of Off-Market Share Buybacks

Discussion Paper

The Board of Taxation

July 2007

© Commonwealth of Australia 2007
ISBN 0 642 74403 3

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to:

Commonwealth Copyright Administration
Attorney-General's Department
Robert Garran Offices
National Circuit
CANBERRA ACT 2600

Or posted at:

http://www.ag.gov.au/cca

Printed by CanPrint Communications Pty Ltd

CONTENTS

FOREWORD v

CHAPTER 1: INTRODUCTION 1

Terms of reference 1

The Review team 2

Review processes 2

CHAPTER 2: BACKGROUND 5

Share buybacks 5

History of off-market share buybacks 6

Purposes of off-market share buybacks 7

Alternatives to off-market share buybacks 9

Developments in off-market share buybacks 10

Policy benchmarks for considering the appropriate taxation treatment 14

CHAPTER 3: CURRENT FRAMEWORK FOR SHARE BUYBACKS 17

Introduction 17

Corporations law 17

Taxation law 19

Tax Office processes 27

Securities exchange Listing Rules 32

Market processes 34

International treatment of share buybacks 36

CHAPTER 4: IMPLICATIONS OF CURRENT TREATMENT OF OFF-MARKET SHARE BUYBACKS 39

For public companies 39

For different shareholders in listed companies 41

For shareholders in unlisted companies 47

For the taxation revenue 48

Compared with other mechanisms 50

CHAPTER 5: ASSESSMENT OF CURRENT TAXATION TREATMENT 51

Introduction 51

Efficiency/Neutrality 51

Equity 58

Simplicity 72

Other considerations 74

APPENDIX A: CONSULTATION QUESTIONS 75
Chapter 2: Background 75
Chapter 3: Current framework for share buybacks 75
Chapter 4: Implications of current treatment of off-market share buybacks 76
Chapter 5: Assessment of current taxation treatment 77
APPENDIX B: OFF-MARKET SHARE BUYBACKS BY LISTED COMPANIES SINCE 1997 81
APPENDIX C: CORPORATIONS LAW EXTRACTS 83
APPENDIX D: TAXATION LAW EXTRACTS 91
APPENDIX E: INTERNATIONAL COMPARISONS 111
APPENDIX F: IMPACT OF OFF-MARKET SHARE BUYBACKS ON EQUITY LEVELS 117
APPENDIX G: SHAREHOLDER PARTICIPATION MODEL 119
APPENDIX H: EMPLOYEE SHARE SCHEME EXAMPLES 123
APPENDIX I: TAX AND ANNOUNCEMENT EFFECTS OF OFF-MARKET SHARE BUYBACKS 125
APPENDIX J: MODEL FOR ASSESSING EQUITY ISSUES 131

FOREWORD

Off-market share buybacks have become an increasingly popular mechanism for listed companies to return equity to shareholders. They are also used by unlisted companies to make changes in ownership structures. Taxation arrangements can be an important consideration in assessing alternative mechanisms for achieving these corporate objectives.

The current taxation arrangements for off-market share buybacks have been in place for some time. Since their introduction, there have been developments in the corporations law arrangements that permit buybacks, the broader taxation arrangements for dividends and capital gains and market practices. Administrative processes for dealing with off-market share buybacks have also been developed by the Australian Taxation Office.

In this context it is timely to review the taxation arrangements for off-market share buybacks to assess whether they continue to be appropriate. The Board therefore welcomes the opportunity to conduct this review.

Consultations with industry and submissions from interested parties will play a crucial role in shaping the Board's recommendations to government.

R F E Warburton AO	J B L Heading
Chairman, Board of Taxation	Member, Board of Taxation

CHAPTER 1: INTRODUCTION

TERMS OF REFERENCE

1.1 On 10 October 2006 the Government announced that it had asked the Board of Taxation to undertake a review of the taxation treatment of off-market share buybacks, and provide a final report to the Treasurer during the second half of 2007.

1.2 In conducting the review, the Board is 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 will cover the use of buybacks by both types of companies.

The Review team

1.4 The Board has 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 is being assisted by members of the Board's Secretariat.

Review processes

Consultation

1.5 The Board plans to consult with all stakeholders that have an interest in off-market share buybacks. When the review was announced in October 2006 the following outline of the review process was placed on the Board's website:

- Targeted consultation would be conducted to assist with the development of the discussion paper, which would be released in the second quarter of 2007.
- The discussion paper would:
  - provide some background to and the framework under which off-market share buybacks operate in Australia;
  - outline the tax treatment of off-market share buybacks for various types of shareholders; and
  - examine issues relating to each of the review criteria mentioned in paragraph 1.2.
- A public consultation process would be conducted, including seeking written submissions from stakeholders, in the second quarter of 2007.

1.6 Since the review was announced the Board has received a number of preliminary submissions that have assisted with the development of this discussion paper.

1.7 The Board has met with a range of stakeholders who have diverse views on the taxation treatment of off-market share buybacks. This targeted consultation process involved meetings with selected corporates that have conducted off-market share buybacks, their legal and financial advisers, fund managers, representatives of a range of institutional investors, and various individuals who have an interest in the debate on off-market share buybacks. The issues raised by these stakeholders are reflected in this discussion paper to the extent that they are relevant to the terms of reference.

1.8 The Board also consulted with the Treasury on the development of legislation relating to off-market share buybacks and with the Australian Taxation Office (Tax Office) about its administrative practices.

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

Consultation meetings

1.10 The Board intends to hold consultation meetings in Sydney on 26 July 2007 and in Melbourne on 31 July 2007 to explore issues raised in this discussion paper. These meetings will be open to all stakeholders. To assist with organising the meetings, stakeholders are asked to register with the Board's Secretariat by phone on 02 6263 4366 or by email at taxboard@treasury.gov.au. The purpose of these meetings is to enable interested stakeholders to seek clarification on any aspects of the review's terms of reference and its scope and to promote stakeholder discussion on the issues raised in this discussion paper and any other relevant issues.

Submissions

1.11 The Board is also inviting written submissions to assist with its review. Submissions should address the terms of reference set out in paragraph 1.2 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A). It is not expected that each submission will necessarily address all of the issues and questions raised in the discussion paper. The closing date for submissions is 24 August 2007. Submissions can be sent by:

Mail to: The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Fax to: 02 6263 4471
Email to: taxboard@treasury.gov.au

1.12 The Board intends to publish submissions on its website as they are received, unless the submitter has requested that the submission remain confidential.

Board's report

1.13 The Board will consider all of the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgment, after taking into account all of the information and experience available to it. The Board expects to provide its report to government before the end of 2007.

1.14 It is expected that the Board's report will be published in conjunction with the Government's response to the report.

CHAPTER 2: BACKGROUND

SHARE BUYBACKS

2.1 Over the last ten years share buybacks have become an increasingly common method for listed companies to return cash to shareholders. A share buyback involves a company buying back its own shares in accordance with the terms and procedures set out in the *Corporations Act 2001* (Corporations Act). Shares that are bought back are cancelled, resulting in a reduction in the number of a company's issued shares. There are a number of different types of share buybacks, with the classification differing for corporations law and taxation purposes.

2.2 There are five different types of buybacks for the purposes of the Corporations Act:

- Equal access scheme: a company makes a uniform offer to all of its shareholders that own ordinary shares to purchase a uniform percentage of those shares.[1]
- On-market buyback: an offer made by a listed company on a prescribed financial market (which includes the Australian Securities Exchange (ASX)) in the ordinary course of trading on that market.[2]
- Employee share scheme buyback: a buyback under a scheme which has as its purpose the acquisition of shares in a company, by, or for the benefit of, employees or directors of the company or a related company and that has been approved by the company at a general meeting.[3]
- Minimum holding buyback: a buyback of all of a holder's shares in a listed company if the shares are less than a 'marketable parcel' within the meaning of the rules of the relevant financial market.[4]

---

1 *Corporations Act 2001*, subsection 257B(2) and (3).

2 *Corporations Act 2001*, subsection 257B(6). It also includes a buyback that results from an offer made in the ordinary course of trading in an approved overseas financial market: *Corporations Act 2001*, subsection 275B(7) and (8) (see also Australian Securities & Investments Commission (ASIC) Class Order 02/249).

3 *Corporations Act 2001*, section 9.

4 *Corporations Act 2001*, section 9.

- Selective buyback: any other kind of buyback,[5] including a buyback involving an offer made to a particular shareholder to the exclusion of all other shareholders as well as 'tender style' buybacks (discussed in further detail in Chapter 3).

2.3 For taxation purposes, there are only two kinds of buybacks:

- On-market buybacks: a buyback undertaken in the ordinary course of trading on a stock exchange in Australia or elsewhere; and
- Off-market share buybacks: being any other kind of buyback.[6] This encompasses all buybacks other than the on-market classification for corporations law purposes.

2.4 Off-market share buybacks include all buybacks undertaken by unlisted companies, as well as buybacks undertaken by listed companies that take place outside the ordinary course of trading on a stock exchange.

HISTORY OF OFF-MARKET SHARE BUYBACKS

2.5 Share buybacks were originally prohibited in Australia on the basis that reductions in share capital could prejudice creditors.[7] Over time, however, it became clear that the prohibition did not necessarily achieve its objective and could be circumvented by companies.

2.6 In 1987, the Companies and Securities Law Review Committee (CSLRC) recommended[8] that the law be amended to enable companies to buy back their own shares as this would:

- increase capital mobility by releasing unneeded funds to shareholders, thereby promoting a more efficient distribution and allocation of capital;
- improve the competitiveness of Australian securities in international financial markets; and
- bring Australia in line with the United States and Commonwealth countries such as Canada and the United Kingdom. There was a concern that Australian companies could be at a disadvantage when competing on world share markets if

---

5 *Corporations Act 2001*, section 9.
6 *Income Tax Assessment Act 1936* (ITAA 1936), section 159GZZZK.
7 This prohibition was contained in section 129(1) of the former Corporations Code and was based on the principle in *Trevor v Whitworth*, House of Lords, 188, which prevented companies from reducing their share capital in order not to prejudice their creditors.
8 Companies and Securities Law Review Committee (CSLRC), *Report to the Ministerial Council - A Company's Purchase of its Own Shares* (1987).

they lacked the flexibility of control over their equity that companies in these countries had.

2.7 As a consequence of the CSLRC's recommendations, provisions were inserted in the *Corporations Act 1989*[9] to allow share buybacks to take place. However, these rules were complex and imposed many stringent requirements and restrictions. The legislation was subsequently simplified in 1995 to facilitate the conduct of share buybacks by relaxing some of these requirements. For example, changes were made to certain mandatory procedures relating to advertisements, declarations and auditors. Importantly, the requirement that a company first exhaust its share premium account before using its profits to fund a buyback was also removed.

2.8 In 1998 the legislation was further amended by introducing a solvency requirement and permitting buybacks of redeemable preference shares as part of a broader reform of the maintenance of capital rules. At the same time, the corporations law was changed to remove the concepts of 'par value' and 'share premium account'. This resulted in a company's paid-up capital and share premium accounts forming one 'share capital account'.

2.9 Along with the original 1989 changes to the corporations law, provisions were introduced into the *Income Tax Assessment Act 1936* (ITAA 1936) to provide for the taxation treatment of share buybacks, both on-market and off-market (Division 16K).

2.10 In 1997 the Tax Office provided a ruling on the first significant off-market repurchase with a deemed dividend component under these provisions to the Commonwealth Bank of Australia. The company bought back 4 per cent of shares outstanding and distributed $164.6 million of previously undistributed franking credits to shareholders participating in the buyback.

PURPOSES OF OFF-MARKET SHARE BUYBACKS

2.11 Off-market share buybacks can be used by companies for a number of different purposes. For listed companies and widely held unlisted companies it has been suggested those purposes[10] may form part of a company's capital management strategy, enabling it to achieve one or more of the following:

- return excess funds which shareholders can redirect to other investments. This enables companies that may be over-capitalised to channel money back to their shareholders who may be able to use it better elsewhere;

---

9 The *Corporations Act 1989* has now been superseded by the *Corporations Act 2001* and the provisions regulating share buybacks are, therefore, now contained in this new Act.

10 Lamba, A and Ramsay, I 2000, *Share Buy-Backs: An Empirical Investigation*, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 24; and Mitchell, J and Robinson, P 1999, *Motivations of Australian Listed Companies Effecting Share Buy-Backs*, (1999) 35 (1) *Abacus* 91.

- release franking credits through the frankable ‘dividend component’ (see paragraph 3.20). This allows companies with substantial franking credits to pass them on to their shareholders in much the same way as they do with ordinary dividend payments;
- maintain a preferred capital structure by altering its debt-to-equity ratio. Once amounts are returned to shareholders and shares are cancelled, a company’s leverage is increased;
- signal indirectly to the market that it believes its share price may be undervalued; and
- increase earnings per share as a result of there being a reduced number of issued shares in the company following a buyback.

2.12 In some cases, buybacks can also be used by companies to make changes in their shareholder structure, including to:

- allow employees to exit employee share schemes through selective buybacks where they are leaving a company by selling their shares back to the company; and
- reduce administrative overheads by enabling companies to buy back small shareholdings and thereby clear up their share registries. This can result in administrative efficiencies and cost savings for the company.

2.13 For closely held unlisted companies in particular, but also in some cases for listed companies, off-market share buybacks may be used to facilitate changes in ownership and control. In particular a buyback can be used as a mechanism to allow shareholders to exit the company. For widely-held unlisted companies and listed companies, buybacks can be used to increase relative ownership and control interests in the company.

2.14 Finance literature suggests two key theories (ignoring tax consequences) that may explain why companies repurchase their shares: the information/signalling hypothesis and the free cash flow hypothesis.[11]

- The information/signalling hypothesis derives from the information asymmetries that exist between managers and outsiders, with managers using share repurchases as a signal of better prospects for the company. Empirical evidence to support the signalling hypothesis is mixed.

---

11 Grullon, G and Michaely, R 2004, ‘The Information Content of Share Repurchase Programs’, *Journal of Finance* 59, 651-680; Brown, C and O’Day, J 2005, ‘The Dividend Substitution Hypothesis: Australian Evidence’, Working paper.

- The free cash flow hypothesis argues that repurchases and dividends (both ordinary and special) are a mechanism to distribute excess cash to shareholders and lower the agency costs of free cash flow. There is some empirical support in Australia and the United States for this hypothesis.

2.15 It has also been found that firms with high leverage are less likely to repurchase their shares. Further, it appears that dividends are used to pay out cash flow that is likely to be permanent, while share repurchases are used for more volatile cash flows.[12]

Q2.1 The Board invites comment on the reasons companies, both listed and unlisted, use off-market share buybacks:

- How significant are each of the above explanations for the use of off-market share buybacks?
- Are there other reasons for the use of off-market share buybacks?

ALTERNATIVES TO OFF-MARKET SHARE BUYBACKS

2.16 In assessing the appropriate taxation arrangements for off-market share buybacks, it is important to consider the issue in the context of the alternatives that might be available to companies and the taxation and other consequences of those alternatives.

2.17 Depending on the purpose for which an off-market share buyback is being conducted, there may be a number of alternatives available to the company. Where an off-market share buyback is being used as part of a company's capital management strategy, the alternatives that might be available (either alone or in combination) to the company include:

- on-market share buybacks;
- increasing dividends;
- special dividends;
- demergers; and
- capital reductions (with or without share cancellation).

12 Jagannathan, M Stephens, C and Weisbach, M 2000, 'Financial Flexibility and the Choice Between Dividends and Stock Repurchases', *Journal of Financial Economics* 57, 355-384; Guay, W and Harford, J, 2000, 'The Cash-Flow Permanence and Information Content of Dividend Increases Versus Repurchases', *Journal of Financial Economics* 57, 385-415.

2.18 For closely held unlisted companies where the objective is to enable one or more shareholders to exit the company, there are three approaches:

- continuing shareholders could purchase the shares of those wishing to exit;
- a selective capital reduction could take place; or
- the shares could be bought back by the company.

2.19 For commercial reasons the third approach may be preferable in some cases because the company may be in the best position to raise the funds or offer the relevant security to pay for the shares. In addition, if the shares are purchased by existing shareholders (and as a result, not cancelled), those shareholders may be subject to taxation on gains made on them in the future.

Q2.2 The Board invites comment on the alternatives to off-market share buybacks available to companies and the purposes for which they are used.

Developments in off-market share buybacks

Unlisted companies

2.20 For closely held unlisted companies, off-market share buybacks became a popular mechanism for shareholders to exit companies because when they were first permitted the procedures were simpler than for capital reductions which required an application to the Supreme Court, with notices to creditors who had rights to appear, be heard and object. Through subsequent changes to the corporations legislation, the procedures for off-market share buybacks and capital reductions were closely aligned. However, even though the outcomes from the two processes are now similar, as companies have become used to the procedures being undertaken by way of buybacks, they continue to be the preferred mechanism.

Listed companies

2.21 While share buybacks were first permitted in 1989, they did not gain acceptance and become prevalent until after the 1995 reforms to the corporations law. Although the first significant off-market share buyback was conducted by the Commonwealth Bank in 1997, off-market share buybacks did not become popular for listed or widely held unlisted companies until around 1999. Early buybacks were offered at a fixed price which was generally close to the market price at the time of the buyback.

2.22 Appendix B contains a list of off-market share buybacks conducted by listed companies since the Commonwealth Bank arrangement in 1997.[13] Up to March 2007, the list includes 50 'equal access'[14] buybacks with only nine of these not involving a franked dividend component. Over the years from 1997 to March 2007 for the companies listed in Appendix B, $25.4 billion was disbursed to shareholders through this vehicle. Franking credits distributed totalled $7.3 billion.

2.23 Since 2003, many of Australia's largest listed companies have undertaken off-market share buybacks using a 'tender' process. This process involves a company inviting its shareholders 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. These processes are discussed in greater detail in paragraphs 3.82 to 3.89.

2.24 By number there are significantly more off-market share buybacks (many thousands) conducted by unlisted companies than by listed companies. However, by value, listed companies have returned a significant amount of cash to shareholders using both off- and on-market share buybacks and this has been growing since around 2001. However, it is still a relatively small amount when compared with the amount returned to shareholders by ordinary dividends. For the period 1996—2003, around $220 billion was returned to shareholders by ordinary dividend payments compared with about $25 billion returned in on-market and off-market share buybacks conducted during that period.[15]

Reasons for growth

2.25 There are likely to be a number of explanations for the increasing use of off-market share buybacks by listed companies in Australia including those outlined below.

Stage of economic cycle

2.26 In recent years many companies have experienced strong trading conditions resulting in increased profits and associated corporate taxes. As a result, franking account balances have increased for these companies. Companies may be reluctant to increase dividend payout rates due to the cyclical nature of these trading conditions and may look to off-market share buybacks as an alternative to distribute profits and franking credits.

---

13 The list does not include selective buybacks, companies that were subsequently delisted, or companies that undertook buybacks that involved securities other than fully paid ordinary shares.

14 These companies obtained relief from ASIC to conduct the buyback on the same terms as an equal access buyback. This process is discussed in paragraph 3.8.

15 Brown, C and O'Day, J 2005, '*The Dividend Substitution Hypothesis: Australian Evidence*', Working paper.

Changes in taxation arrangements

2.27 A number of changes have been made to the taxation system, since the dividend imputation system was first introduced in 1987 and off-market share buybacks were first permitted under corporations legislation, which may have impacted on the relative attractiveness of off-market share buybacks to different classes of shareholders.

Refund of franking credits

2.28 When the dividend imputation system was introduced in 1987, for taxpayers on marginal tax rates lower than the company tax rate, any excess franking credits (franking rebate) could be used to offset income tax on other income, but were not refundable in cash where the credit and other prepayments of tax exceeded total tax payable. Amendments were made in 2000 to enable such taxpayers (including superannuation funds with a 15 per cent tax rate and certain charities and deductible gift recipients) to receive a refund of franking credits.

2.29 In addition, the pool of available franking credits has grown significantly since the imputation system was introduced.

Changes in tax rates and the treatment of capital gains

2.30 When dividend imputation was introduced in 1987 the company tax rate and the top personal income tax rate were aligned for a short period at 49 per cent. As a result, where dividends were fully franked no additional tax was paid by any taxpayer on those dividends. Real capital gains were fully taxable until 1999. At present the corporate tax rate is 30 per cent and the top marginal tax rate is 45 per cent and for individuals and superannuation funds capital gains are discounted by 50 per cent and 33 ⅓ per cent, respectively, where an asset has been owned for at least 12 months. This discounting increases the value of capital gains, but reduces the benefits of capital losses. Conversely, there are significantly fewer pre-CGT assets, which previously created a bias in favour of capital returns over dividends. Thus, there have been changes in the relative attractiveness of dividends and capital gains for taxpayers in different circumstances.

2.31 When combined, these changes are likely to have had some impact on the relative attractiveness of off-market share buybacks for particular types of taxpayers compared with the alternative mechanisms for returning capital to shareholders. In particular, as Chapter 4 shows, off-market share buybacks have become particularly attractive for superannuation funds, charities and deductible gift recipients, and less attractive for high marginal rate and non-resident taxpayers, particularly when compared with the sale of shares on-market.

2.32 These impacts have been heightened by the significant growth in recent years of superannuation funds under management, from $484.2 billion in June 2000 to

$1.1 trillion in March 2007.[16] Of those funds under management, the largest investment class is equities and unit trusts (50 per cent).[17] Thus, not only are off-market share buybacks more attractive for superannuation funds, there are substantially more opportunities for superannuation funds to participate in such buybacks.

Changes in corporations legislation

2.33 As noted, the requirements in the corporations legislation affecting off-market share buybacks have progressively been loosened, creating greater flexibility in their interaction with the taxation law.

2.34 The changes in the 1990s made it easier for companies to return capital to their shareholders and enabled them to determine the extent to which they used their profits and share capital to fund the purchase price of a buyback. This created the potential for companies to stream different kinds of distributions to shareholders. In response to this and other possible arrangements for capital and dividend streaming and franking credit trading schemes a number of integrity measures were added to the ITAA 1936 in 1998.[18]

Changes in market practices

2.35 The development of a tender process for off-market share buybacks (outlined in paragraph 3.82) which has resulted in shares being bought back at a discount by listed companies has also influenced the relative attractiveness of off-market share buybacks for both companies and shareholders on different marginal tax rates. This tender and discounting process has been facilitated by the refund of franking credits to superannuation funds and charities and deductible gift recipients who are prepared to sell their shares back at a discount as a result of the refund.

Q2.3 The Board invites comment on the reasons for the growth in use of off-market share buybacks:

- How significant are the explanations given above in driving the growth of off-market share buybacks?
- Are there other explanations for the growth in the use of off-market share buybacks?

---

16 Australian Prudential Regulation Authority (APRA), 2007, *Quarterly Superannuation Performance, March 2007.*

17 APRA, 2007, *Annual Superannuation Bulletin.*

18 By *Taxation Laws Amendment Act (No. 3) 1998; Tax Law Amendment (Company Law Review) Act 1998.*

POLICY BENCHMARKS FOR CONSIDERING THE APPROPRIATE TAXATION TREATMENT

2.36 In considering whether the current taxation treatment of off-market share buybacks is appropriate and assessing any possible changes, it is necessary to determine the policy objectives that the provisions should be seeking to achieve. At the broadest level the taxation law should be directed at raising revenue in the most efficient, equitable and simple way. There may also be other policy objectives behind particular taxation measures. In considering particular measures, there will often be trade-offs between these objectives.

Efficiency

2.37 In relation to off-market share buybacks, efficiency can be considered at a number of levels. As a mechanism for achieving particular objectives for companies (outlined in paragraphs 2.11 to 2.13), the issue is whether the current taxation treatment provides the same outcome regardless of the way in which the company achieves that objective. That is, the taxation treatment does not provide an incentive for a company to use one mechanism over another.[19] If the taxation arrangements increase the attractiveness of one mechanism over another, the overall efficiency of the economy will be reduced. However, there may be other non-tax reasons for preferring one mechanism over another.

2.38 At a broader economy-wide level, as noted in paragraph 2.11, one of the potential uses of off-market share buybacks is to facilitate the return of excess capital to shareholders. If shareholders use the returned capital in more productive ways than the company would otherwise have done, this could lead to a more efficient use of those resources and increase the productive capacity of the economy.

2.39 However, this needs to be considered in the context of other mechanisms for returning capital to shareholders and the extent to which they are facilitated by the current taxation treatment. Any efficiency gains need to be assessed both absolutely and by comparison with other mechanisms for achieving capital market efficiency and other ways of using taxation revenue.

2.40 There is also an international dimension that needs to be considered. If Australia's taxation treatment is less generous or flexible than that of other countries, this could reduce the competitiveness of our companies operating in international markets and the attractiveness of their shares to international investors. It could also to some degree reduce the attractiveness of Australia as a location for companies by increasing the cost of raising capital in our markets. This has to be balanced against domestic revenue raising considerations.

---

19 There should be a constant relationship between pre and post tax rates of return.

Equity

2.41 There are two dimensions to equity — horizontal and vertical. The first has the objective of ensuring that taxpayers in similar circumstances are treated similarly, while the second relates to the progressivity of the tax system.

2.42 In addition, in relation to the former, one of the underlying principles of the imputation system is that tax paid at the company level is in broad terms imputed to shareholders proportionately to their shareholdings. Consequently, there will be some shareholders who cannot use, or cannot fully use, imputation benefits but will nevertheless receive franked distributions. This results in the wastage of those benefits (franking credits), which is a design feature of the imputation system. Dividend streaming, that is, the distribution of franking credits to select shareholders, undermines this principle by attributing tax paid on behalf of all shareholders to only some of them.[20] To prevent dividend streaming, there are several anti-streaming measures as well as the general anti-avoidance rule (discussed in further detail in Chapter 3).

2.43 Dividend streaming also has an impact on the revenue raised by the taxation system. It enables franking credits to be distributed to those shareholders who can make greater use of them than others, reducing the wastage of franking credits and resulting in a reduction in the overall revenue raised from companies and their shareholders.

2.44 The extent to which the taxation treatment of off-market share buybacks favours particular types of shareholders may also have an impact on vertical equity. As noted in Chapter 4, the current arrangements may increase, rather than reduce, the progressivity of the tax system

Simplicity

2.45 A key focus of the Government, reflected in the Board's terms of reference for this review, is to reduce unnecessary compliance costs faced by taxpayers. Compliance costs can be driven by both the content of the tax law and the administrative process involved in complying with the provisions.

Other considerations

2.46 It is also important to note that the taxation arrangements in relation to off-market share buybacks operate in the broader context of the taxation system as a whole. They are impacted by a range of other provisions and form part of the broader set of arrangements for taxing the income of companies. Further, changes made in one part of the tax law can have implications for other parts of the tax law.

---

20 Explanatory Memorandum to *Taxation Laws Amendment Act (No. 3) 1998*, page 59.

2.47 In considering the policy objectives in relation to off-market share buybacks it is necessary to do so in the context of the policy objectives of that broader set of arrangements. In particular, any changes made to the taxation treatment of off-market share buybacks needs to take account of the broader context and the potential linkages and impacts.

Q2.4 Are these the appropriate policy objectives to consider?

Q2.5 Are there other policy objectives that should be considered?

Q2.6 Is the current balance between them appropriate?

Q2.7 Are there particular linkages and impacts with other parts of the tax system that the Board needs to be aware of?

CHAPTER 3: CURRENT FRAMEWORK FOR SHARE BUYBACKS

INTRODUCTION

3.1 The way in which off-market share buybacks operate is dependent on corporations law rules, taxation law, securities exchange requirements, Tax Office administrative practice and general market practices.

CORPORATIONS LAW

3.2 The corporations law rules dealing with share buybacks are mainly contained in Part 2J.1 of the Corporations Act.[21] Those provisions permit a company to buy back its shares if:

- the buyback is fair and reasonable to the company's shareholders as a whole;
- the buyback does not materially prejudice its ability to pay its creditors; and
- the procedures in Division 2 of Part 2J.1 are followed.

3.3 A company can use amounts standing to the credit of its share capital account as well as other accounts (for example, profits) to fund the share buyback.

3.4 The procedures in Division 2 of Part 2J.1 differ depending on how the buyback is classified. Table 3.1 outlines the procedures for each category of buyback. Depending on the kind of buyback, the relevant procedures may require particular kinds of resolutions to be made approving the buyback and compliance with certain notice, lodgment and disclosure requirements.

---

21 *Corporations Act 2001*, section 256A; sections 257A to 257J.

Table 3.1: Corporations Act procedures for share buybacks[22]

Procedures	Minimum holding	Employee share scheme		On-market		Equal access scheme		Selective buyback
		within 10/12 limit	over 10/12 limit	within 10/12 limit	over 10/12 limit	within 10/12 limit	over 10/12 limit	
Ordinary resolution [257C]	--	--	yes	--	yes	--	yes	--
Special/unanimous resolution [257D]	--	--	--	--	--	--	--	yes
Lodge offer documents with ASIC [257E]	--	--	--	--	--	yes	yes	yes
14 days notice [257F]	--	yes	yes	yes	yes	yes	yes	yes
Disclose relevant information when offer made [257G]	--	--	--	--	--	yes	yes	yes
Cancel shares [257H]	yes	yes	yes	yes	yes	yes	yes	yes
Notify cancellation to ASIC [254Y]	yes	yes	yes	yes	yes	yes	yes	yes

3.5 As a general rule, except in the case of a selective buyback, companies can offer to buy back up to 10 per cent of their shares within a 12-month period (this is known as the '10/12 limit').[23] Offers outside the '10/12 limit' will generally require an ordinary resolution to be passed by shareholders at a general meeting.[24]

3.6 From a shareholder's perspective, a share buyback is much like any other share sale as it involves the transfer of shares. However, from a company's perspective, a share buyback differs from an ordinary share purchase, as the company does not become the owner of the shares. Instead, once a buyback agreement has been entered into, all rights attaching to the shares are suspended and, immediately after the registration of the transfer, the shares are cancelled.[25]

3.7 Initially companies were required to exhaust the share premium account before sourcing buyback funds from profit. As noted in paragraph 2.7, this restriction was removed in 1995, enabling companies to choose how much of the purchase price is sourced from profit and treated as a deemed dividend for tax purposes. Subsequent changes in 1998 removing the concepts of par value and share premium account and

---

22 This table is replicated from section 257B of the *Corporations Act 2001*.

23 The '10/12 limit' for a company proposing to make a buyback is 10 per cent of the smallest number, at any time during the last 12 months, of votes attaching to voting shares of the company: *Corporations Act 2001*, section 257B(4).

24 *Corporations Act 2001*, section 257C.

25 *Corporations Act 2001*, section 257H. Within one month of the cancellation, the company must lodge with ASIC a notice in the prescribed form stating the number and class of shares cancelled and the consideration paid for the buyback: *Corporations Act 2001*, section 254Y.

creating the concept of a share capital account also made it easier to make distributions of capital. Currently, neither accounting standards nor any other rules or guidelines prescribe how a company should allocate the buyback price between retained earnings, reserves and share capital.

3.8 The tender process for conducting off-market share buybacks outlined in paragraph 3.82 does not satisfy the requirements of an equal access buyback under the Corporations Act. The company does not offer to buy shares, but rather invites shareholders to make offers to sell shares to the company. Although invitations relate to all of each holder's shares, shareholders may offer to sell only some of their shares. As a result, such buybacks are categorised as selective buybacks which usually require a special resolution to be passed at a general meeting by those shareholders whose shares are not being bought back, or a unanimous resolution agreed to at a general meeting by all ordinary shareholders.[26] Generally listed companies are able to obtain approval from the Australian Securities & Investments Commission (ASIC) to treat off-market share buybacks as 'equal access' so long as each shareholder has the same opportunity to participate in the buyback.[27] 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.

3.9 There are a number of other provisions in the Corporations Act that may have potential relevance to the conduct of off-market share buybacks. Section 254W specifies that each share in a class of shares in a public company has the same dividend rights unless the company's constitution provides for the shares to have different dividend rights or different dividend rights are provided for by special resolution of the company. In considering whether to conduct an off-market share buyback, directors are also subject to their general duties to act in good faith in the best interests of the corporation and for a proper purpose.[28] The application of these provisions is discussed in further detail in paragraphs 5.27 to 5.35.

3.10 Appendix C contains relevant extracts from the Corporations Act.

TAXATION LAW

3.11 The taxation rules dealing with share buybacks are in Division 16K of Part III of the ITAA 1936.[29] The provisions apply to both the company that buys back its shares and the shareholders whose shares are bought back. The provisions operate in conjunction with the general taxation rules located elsewhere in the tax legislation. In

---

26 *Corporations Act 2001*, section 257D(1).

27 *Corporations Act 2001*, section 257D(4). Its 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).

28 *Corporations Act 2001*, section 181.

29 ITAA 1936, sections 159GZZZIA to 159GZZZS.

particular, they work with the ordinary income, general deduction, capital gains tax (CGT), dividend, imputation and withholding tax rules contained in the ITAA 1936 and *Income Tax Assessment Act 1997* (ITAA 1997).

3.12 From the company's perspective, the cancellation of its shares under a buyback has no income tax or CGT consequences.[30] A buyback may, nevertheless, have franking consequences for the company.

3.13 From a shareholder's perspective, the tax consequences of a buyback depend on whether it is classified as an 'on-market purchase' or an 'off-market purchase'. In an on-market purchase, the shareholder is not usually aware that the company is the purchaser of the shares since the transaction occurs in the ordinary course of trading on a stock exchange through brokers. For this reason, shareholders who participate in an on-market buyback are taxed in the same way as if they sold their shares under an 'ordinary sale' to a third party. In contrast, in an off-market purchase, the shareholders will know that the company is the purchaser of their shares as the company will have made a specific offer to buy their shares or invited the shareholders to tender their shares for sale. This offer or invitation will generally advise shareholders of the accounting implications of the purchase price for the company.

3.14 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).[31] It will also depend on whether the purchase price paid for a share is greater than, equal to, or less than its 'market value'.

3.15 Other factors that affect the tax consequences of a share buyback include:

- the shareholder's residency status;
- the shareholder's tax rate and profile (for example, whether the shareholder is an individual, company, superannuation fund or other kind of entity);
- the cost base of the shares, and whether they are pre or post CGT; and
- the manner in which the shareholder holds the shares (for example, as 'revenue' or 'capital' assets).

3.16 The operation of the share buyback rules also needs to be considered in the context of a number of specific anti-avoidance provisions in the tax legislation. These provisions are discussed in further detail in paragraphs 3.32 to 3.47.

---

30 ITAA 1936, Section 159GZZZN.

31 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.

Off-market share buybacks

3.17 The provisions relating to off-market purchases recognise that shareholders that sell their shares under an off-market share buyback may receive a payment that consists of a 'dividend component' and/or a 'capital component'.[32]

3.18 This reflects the fact that some of the purchase price may be a distribution of the company's profits (and should be taxed as a dividend), while the remainder of the purchase price may be a return of the company's share capital (and should be treated as consideration for the sale of the share). The rationale for allowing part of an off-market share buyback to be paid as a dividend was to ensure consistent treatment with the rules on returns of capital, cancellations and liquidations.[33]

3.19 On the face of the law the extent to which the purchase price is a dividend component and/or a capital component in the hands of shareholders appears to depend on how the company debits its accounts. However, the company's decision needs to bear in mind the potential application of the anti-avoidance and dividend and capital streaming provisions.

The dividend component of the purchase price

3.20 The 'dividend component' of the purchase price is the difference between the purchase price paid for a share and that part of the purchase price which is debited against the company's share capital account.[34]

3.21 As a general rule, this dividend is a 'frankable distribution'[35] and the company may allocate franking credits to it. However, 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'.[36] This limitation is designed to prevent a company paying a higher franked dividend than would otherwise be possible.[37] The dividend component is taxed in the same way as ordinary dividends under the general taxation rules.

The capital component of the purchase price

3.22 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, in order to obtain a class and/or private ruling which will often be

---

32 ITAA 1936, Subdivision C of Division 16K — section 159GZZZP and section 159GZZZQ.

33 However, the treatment of the capital component of the purchase price differs as between off-market share buybacks and returns of capital, cancellations and liquidations.

34 ITAA 1936, Section 159GZZZP.

35 *Income Tax Assessment Act 1997* (ITAA 1997), section 202-40.

36 ITAA 1997, section 202-45.

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

regarded as a commercial necessity for the buyback to proceed, it needs to be determined using a methodology acceptable to the Tax Office.

3.23 In some circumstances the 'capital component' received by a shareholder is adjusted to take account of 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 'market value uplift rule'.[38] This rule applies 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'. Where that is the case, the consideration for the sale is deemed to be the market value of the share at that time. The practical effect of this rule is that it:

- reduces the amount of any capital loss or revenue loss that might otherwise arise to the shareholder on the sale of the share; or
- increases the amount of any capital gain or income gain that might otherwise arise to the shareholder on the sale of the share.

3.24 The key issue in applying this rule is determining what the market value of a share would be 'if the buyback did not occur and was never proposed to occur'. This requires the market value of a share to be calculated based on the premise that the buyback is ignored (that is, assuming it was never announced and never took place).

3.25 The Tax Office has developed a formula to be used for calculating the market value of shares in an ASX listed company in *Taxation Determination* TD 2004/22. It 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 first announcement of the buyback, adjusted for the percentage change in the 'S&P/ASX 200 Index' from the commencement of trading on the first announcement date (the 'Opening S&P/ASX 200 Index') to the close of trading on the day the buyback closes (the 'Closing S&P/ASX 200 Index').

$$\text{VWAP over last five trading days} \times \frac{\text{Closing S\&P/ASX 200 Index}}{\text{Opening S\&P/ASX 200 Index}}$$

3.26 The amount of the 'market value uplift' can not be calculated until the buyback price has been determined, which, under a tender-style buyback, will not be until the buyback has actually closed.

3.27 Companies requesting a variation to the formula in TD 2004/22 need to make out a case to the Tax Office that their alternative formula gives a more accurate reflection of the share's market value than the approach in that determination.

38 ITAA 1936, subsection 159GZZZQ(2).

3.28 For unlisted companies, the deemed market value is likely to be determined in negotiations between the exiting and remaining shareholders. The Tax Office would usually require a valuation to support the negotiated market value.

On-market purchases

3.29 Where a buyback takes place on-market, no part of the purchase price is treated as a dividend.[39] This is the case even though a company may have debited its profits in making the buyback. The seller is deemed to have received as consideration for the sale, the purchase price paid for the share. Thus, from a shareholder's perspective, an on-market buyback produces the same taxation result as an ordinary sale of shares.

3.30 Although companies that undertake on-market buybacks do not pay any dividends to their shareholders, if all or part of the buyback is sourced from profits, they may still be required to debit their franking account by an amount equal to the debit that would have arisen if:

- the purchase of the share were a frankable distribution equal to the one that would have arisen if the company had purchased the share off-market; and
- the distribution were franked at the company's benchmark franking percentage for the franking period in which the purchase was made or, if the company does not have a benchmark franking percentage for the period, at a franking percentage of 100 per cent.[40]

3.31 This special franking rule results in the reduction of a company's franking account balance without any corresponding franking credit benefit being passed on to its shareholders. In practice, nowadays companies are unlikely to fund an on-market buyback from profits.

Anti-avoidance provisions

3.32 The share buyback rules need to be considered in the context of a number of specific anti-avoidance provisions. These provisions target particular arrangements on both the dividend and capital sides, such as franking credit trading and streaming schemes. Where the anti-avoidance provisions operate, they may result in:

- shareholders being denied imputation benefits (franking credit tax offsets);
- penalty debits arising in companies' franking accounts; or
- capital benefits being treated as unfranked dividends.

---

39 ITAA 1936, subdivision D of Division 16K — sections 159GZZZR and 159GZZZS.

40 ITAA 1997, section 205-30.

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

- the 'qualified person' rule contained in paragraph 207-145(1)(a) ITAA 1997;
- 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 ITAA 1936; and
- the general anti-avoidance provision for franking credit trading contained in section 177EA ITAA 1936.

The qualified person (45 day) rule

3.34 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'.

3.35 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.

3.36 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).[41] 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.[42]

3.37 The holding period rule generally operates on a 'last in first out' 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 be denied franking credits if they subsequently purchase additional shares before the buyback closes.

3.38 These rules were not designed specifically to deal with off-market share buybacks. Rather, they were introduced to deal with securities lending and similar arrangements.

The anti-streaming rule

3.39 The Commissioner has a discretion to deny the benefits of streaming if a company 'streams' distributions in such a way that:

---

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

42 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.

- an 'imputation benefit' is, or would be, received by a shareholder as a result of the distributions; and
- 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.

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

- the franking account of the company should be debited; and/or
- the shareholder who receives greater benefits should be denied the imputation benefit.

The capital benefit streaming and substitution rules

3.41 Sections 45A and 45B apply to arrangements involving the 'provision of capital benefits'. 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 Commissioner may treat some or all of the capital benefits as unfranked dividends.

3.42 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.

3.43 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.

3.44 A taxpayer obtains a 'tax 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 imputation benefit scheme rule

3.45 Section 177EA applies to a 'scheme' for the disposition of membership interests or interests in membership interests. Such a scheme would cover a scheme for the sale of shares under a buyback. The section applies where a franked distribution is paid, is payable or flows indirectly to a person in respect of such interests and where, having regard to the relevant 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 obtaining an 'imputation benefit' for the relevant taxpayer.

3.46 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.

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

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

3.48 Appendix D contains relevant extracts from the tax legislation.

The Review of Business Taxation

3.49 The tax treatment of share buybacks was considered by the Review of Business Taxation in 1999.[43] That review noted:

- the treatment of distributions arising from on-market buybacks was inconsistent with the treatment of dividends and could give rise to double taxation, as the full amount of the buyback distribution is treated as consideration for the sale of the shares (for example, for CGT purposes). However, if the consideration for the buyback was sourced from profits, the company would be regarded as having distributed a dividend. Consequently, a franking account debit arises, without any benefit to the shareholder.
- The potential for double taxation does not occur with off-market share buybacks as the company buying back the shares determines the source of funds. The amount of the buyback sourced from profits is treated as a dividend. Only the amount sourced from capital is treated as consideration for the disposal of the shares, allowing the offsetting capital loss to the shareholder. The Review

---

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

concluded that the current tax treatment of off-market share buybacks was appropriate, subject to how the relative proportions of profit and capital in the buyback were determined.

3.50 The role of the capital loss in removing double taxation is illustrated in the example below.

Removing double taxation

Shareholder X has purchased a share for $10 in BCo. Subsequently, BCo earns profits of $100 with respect to the share and pays $30 in company tax. Shareholder X then sells the share to Shareholder Y for $80. That sale gives rise to a capital gain of $70 for Shareholder X, upon which tax is paid at Shareholder X's marginal rate (assuming that Shareholder X cannot access any CGT discount).

Note that the capital gain reflects the value of retained profits in the company. Essentially the capital gains tax system is taxing corporate income that has already suffered tax at the corporate level.

BCo then offers to purchase Shareholder Y's share in an off-market share buyback for $80 and distributes profits and capital in respect of the share. Therefore, under the buyback Shareholder Y receives a fully franked dividend of $70 and a capital component of $10.

As Shareholder Y bought the share for $80, she will make a capital loss of $70. However, she will be taxed on the dividend component of the buyback price at shareholder Y's marginal rate. That is, Shareholder Y is taxed on $100 grossed-up dividend at the personal marginal tax rate and, as the dividend is fully franked, shareholder Y will receive a $30 refundable tax offset.

Overall, assuming that both Shareholder X and Shareholder Y are on the same marginal tax rate, the off-market share buyback eliminates the original double taxation of corporate profits because the overall tax paid on the company profits is the personal marginal tax rate. Shareholder Y makes a capital loss equal to the capital gain made by Shareholder X, leaving only the franked dividend component, which is taxed at the personal marginal tax rate.

TAX OFFICE PROCESSES

3.51 There are a number of mechanisms through which the Commissioner can provide guidance and advice both to taxpayers and to Tax Office staff on the Commissioner's opinion of the interpretation of particular aspects of the taxation law, or on the circumstances in which the Commissioner will exercise a discretion granted to him under the law. They are a way of providing greater certainty and consistency in the application of the law. In particular the Tax Office may issue:

- generally applicable public rulings and tax determinations;

- class rulings applicable to specific classes of taxpayers;
- private binding rulings; and
- practice statements as to the general way in which various parts of the law will be administered.

3.52 In relation to off-market share buybacks, the Tax Office has issued a tax determination, class rulings and private rulings and has recently released a practice statement. Almost all public companies engaged in an off-market share buyback seek a class ruling (in respect of their shareholders) and generally also a private binding ruling (in respect of themselves).

Tax determinations

3.53 As noted in paragraph 3.25, the Tax Office has issued TD 2004/22 on the method for calculating the market value of shares in relation to off-market buybacks by listed companies.

Class rulings

3.54 Class rulings are public rulings that enable the Commissioner to provide legally binding advice in response to a request from an entity seeking advice about the application of a relevant provision to a specific class of persons, in relation to a particular scheme. The purpose of a class ruling is to provide certainty to participants and minimise the need for individual participants to seek private rulings.

3.55 Since the introduction of class rulings by the Tax Office in 2001, almost all of the listed companies conducting off-market share buybacks have sought a class ruling on the implications of the buyback for the shareholders participating in the buyback. The Tax Office provides a checklist of items for a company seeking a class ruling. It has published almost 40 class rulings on share buybacks since 2001.

3.56 While there has been some variation in the class rulings, they have generally covered the following issues:

- 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

3.57 A private ruling gives the Commissioner’s written opinion about the way a tax law applies to a person’s circumstances for a specified year of income. Again, in most

cases listed companies have sought private rulings in relation to their off-market share buybacks. These private rulings look at the implications of the buyback for the company and address more specifically, issues around:

- the determination of market value;
- the dividend/capital split; and
- the application of the anti-avoidance provisions.

3.58 The issues dealt with in both the class rulings and the private binding rulings are outlined in greater detail in the practice statement discussed below.

Practice statement

3.59 Practice statements are instructions and practical guidance provided to Tax Office staff in considering particular provisions in the tax law. Like tax determinations, they operate as general guidance, rather than applying to a particular situation. The Tax Office has recently released a practice statement, PLSA 2007/9 (available from the Tax Office's legal database at www.ato.gov.au), on the application of various taxation laws in connection with on-market and off-market share buybacks. The practice statement brings together the Tax Office view of the various matters considered in class rulings and private binding rulings. It is an expression of the Tax Office's current practice and does not constrain the Board of Taxation's review. Some of the key issues dealt with in the practice statement are outlined below.

Q3.1 The matters outlined in the practice statement are relevant to the Board's review and the Board welcomes comment on them as part of this discussion paper process.

Market value

3.60 The practice statement confirms the Tax Office's adoption of the methodology for determining the market value of shares in an off-market share buyback outlined in TD 2004/22. It notes the Tax Office view that companies requesting a variation to the formula in that tax determination need to make out a case that their alternative formula gives a more accurate reflection of the share's market value than the approach in the determination.

3.61 The practice statement also indicates that a company's share price may be affected by matters other than the off-market share buyback, including for example that the share is *cum-dividend* and allow for the adjustment of market value to reflect this.

First announcement date of share buyback

3.62 In determining the market value of a share it is necessary under the Tax Office's approach to ascertain the 'first announcement date' of the buyback. Paragraph 2 of TD 2004/22 states that:

> 'The first announcement date will be taken to be the first time the company indicated to the market place that the buyback was in serious contemplation. This may be earlier in time than when the company officially announces the details of the buyback.'

3.63 TD 2004/22 also provides a number of examples as a guide.

Capital/dividend split

3.64 A key element of any off-market share buyback is the 'split' between the return of capital and the dividend paid to participating shareholders. While the split is nominated by the company, the Tax Office has regard to the various anti-avoidance and integrity rules in providing advice to companies. For example, a 'split' that has too low a capital component will both stream dividends and increase capital losses to participating shareholders. Conversely, a capital component that is too high will stream capital benefits at the expense of dividends. As a result, the Tax Office determines what is considered appropriate to avoid application of the anti-avoidance provisions.

3.65 The Tax Office has indicated that there are a number of acceptable methodologies for ascertaining the capital/dividend split, although not all will be applicable in every case. The issue is which is the appropriate methodology in each case. The methodologies outlined by the Tax Office in its practice statement are:

- average capital per share;
- share capital to retained earnings ratio (slice approach); and
- embedded value.

3.66 The Tax Office has indicated that it will generally apply the average capital per share approach unless companies can demonstrate exceptional circumstances for the use of an alternative methodology.

Application of the general anti-avoidance provision for franking credit trading

3.67 There are a number of factors that the Tax Office will take into account in considering the application of section 177EA. One is whether the share buyback timetable provides an opportunity for investors to purchase shares for the purpose of selling them into the buyback, enabling them to access the franking credits attached to the dividend component. This may be the case if the announcement date is earlier than the last day that a person may acquire shares and still be a qualified person in relation

to the dividend paid on shares sold into the buyback and may attract the operation of section 177EA, resulting in a debit to a company's franking account.

3.68 The ASX Listing Rules require there to be at least seven clear business days between the 'Announcement Date' of an equal access share buyback and the 'Record Date'. In these cases shares will trade ex-entitlement three days after the Announcement Date.

3.69 There may be commercial reasons for a longer period between the Announcement Date and the acceptance of offers in relation to the buyback. The practice statement indicates that where this is the case, a timetable that allows for a maximum of seven clear business days between Announcement Date and Record Date will be acceptable to the Tax Office.

3.70 More generally in considering the application of section 177EA, the Tax Office considers whether the buyback results in:

- the delivery of franking credits in excess of what would have otherwise been distributed in the ordinary course of dividend declaration;
- the greater attraction of the buyback to resident shareholders who could fully utilise the franking credits than to non-resident shareholders who could not;
- the greater attraction of the buyback to some resident shareholders with a low marginal tax rate than other resident shareholders (see Chapter 4); and
- participating shareholders making an economic gain, but a loss for taxation purposes, from their participation.

3.71 The Commissioner has determined that section 177EA applied to most of the off-market share buybacks considered in the class rulings on the basis that, having regard to the relevant circumstances of the schemes, the requisite purpose existed in the majority of cases.

3.72 In considering whether to exercise his discretion to debit the company's franking account and/or deny franking credits to participating shareholders, the Commissioner considers the maximum level of discount or minimum buyback price proposed in an off-market share buyback to be a relevant consideration in the exercise of his discretion. He does so on the basis that the level of discount influences the attractiveness of the buyback offer to particular types of shareholders. Deep discounts will make a buyback attractive to only zero or low-rate taxpayers. In considering whether to deny franking credits to participating shareholders, the Tax Office has indicated that the maximum level of discount that it will regard as acceptable is 14 per cent, calculated by reference to the VWAP of the shares for the five days up to and including the closing date of the buyback. In those cases the Commissioner has not

applied his discretion under paragraph 177EA(5)(b) to deny imputation benefits to shareholders.

3.73 Although the Commissioner does not deny franking credits to shareholders, even if the maximum discount is 14 per cent or less, he will normally exercise his discretion to debit the franking account of the company to compensate the revenue for the avoiding wastage of franking credits through streaming of franked dividends. At present this is generally done in cases where non-resident to resident streaming has been identified.

3.74 The formula that the Tax Office uses to calculate the avoided wastage of franking credits is:

Number of shares bought back	x	Franking credit attached to each	x	Percentage of non-residents	x	0.5[44]

Application of the anti-dividend streaming rule[45]

3.75 The Commissioner has concluded that the requirements of these provisions were satisfied in many of the off-market share buybacks considered in his class rulings. The main reason for this was that a significant portion of the shareholders in the relevant companies were non-residents and as a result did not fully benefit from franking credits. The practice statement indicates that, nevertheless, the Commissioner will generally not make a determination under the provision in cases where he intends exercising his discretion under section 177EA.

Application of the capital benefit streaming rule

3.76 The Commissioner has generally ruled that:

- section 45A did not apply to the relevant buybacks as there was no streaming of capital benefits to some shareholders and dividends to other shareholders; and
- section 45B did not apply to the relevant buybacks as the requisite purpose of enabling shareholders to obtain a tax benefit was not present.

Securities exchange Listing Rules

3.77 The ASX Listing Rules also contain specific provisions in relation to on-market and off-market share buybacks with which listed companies are required to comply.

3.78 Under the continuous disclosures provisions of the Listing Rules, when a company decides to undertake a buyback, it must immediately make an announcement

44 This takes into account the fact that franking credits offset withholding tax liability of 15 per cent.
45 ITAA 1997 section 204-30.

to the market (that is, to the ASX).[46] The following information must be included in any such announcement:

- name of entity;
- type of buyback;
- class of shares which is the subject of the buyback;
- voting rights (for example, one for one);
- whether shares are fully paid/partly paid (and if partly paid, details of how much has been paid and how much is outstanding);
- number of shares in the class on issue;
- whether shareholder approval is required for the buyback;
- reason for the buyback; and
- any other information material to a shareholder's decision whether to accept the offer (for example, details of any proposed takeover bid).

3.79 For off-market share buybacks, the following additional information is required:

- percentage of shares proposed to be bought back;
- total number of shares proposed to be bought back if all offers are accepted;
- price to be offered for shares; and
- Record Date for participation in offer.

3.80 If the buyback is on-market, the following additional information is required:

- name of broker who will act on the company's behalf;
- if the company intends to buy back a maximum number of shares, that number;
- if the company intends to buy back shares within a period of time, that period of time;
- if the company intends that the buyback be of unlimited duration, that intention; and
- if the company intends to buy back shares if conditions are met, those conditions.

---

46 Australian Securities Exchange (ASX), Listing Rules Chapter 3 and Appendix 3C.

3.81 The Listing Rules also set out the timetable of events for off-market share buybacks. Under the relevant rule, the company undertaking the buyback is required to give a minimum of seven business days notice between the date the buyback is announced to the market (the Announcement Date) and the Record Date, being the date by reference to which the company will determine whether a person is entitled to participate in the buyback. For most corporate actions, listed securities are quoted on an 'ex-basis' three business days after the Announcement Date. In the context of an off-market buyback, this means that for a person to be eligible to participate in the buyback, the person must have purchased shares in the company no later than the third day after the Announcement Date.

MARKET PROCESSES

3.82 As noted in Chapter 2, market processes in relation to off-market share buybacks have evolved and since 2003 most off-market share buybacks by listed companies have involved a tender process, whereby 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. In addition to tender prices and tender discounts shareholders may offer to sell their shares at a 'final price', which is at whatever price is ultimately determined under the tender process.[47] Shareholders can nominate how many shares they offer to sell at each increment subject to any limits imposed by the company.

Examples of tender approach

Tender prices: In 2004, Telstra conducted an off-market share buyback. Shareholders were invited to tender their shares within the range of $4.05 to $4.65 per share (at increments of 10 cents).

Tender discounts: In 2006, BHP Billiton Limited conducted an off-market share buyback. Shareholders were invited to tender their shares at a discount within the range of 8 per cent to 14 per cent (at increments of 1 per cent) to the market price calculated by reference to the VWAP of the shares for the five days up to and including the closing date of the buyback. Accordingly, if the market price of a share at such time was $10, a shareholder that submitted a tender discount at 10 per cent would be offering to sell their shares for $9 (that is, $10 – ($10 x 10 per cent)).

3.83 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

47 '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 formulas specified in the buyback documents).

market value of the shares occurring after the tender is made but before the buyback closes.

3.84 The success of a shareholder's tender will depend on a range of factors, including:

- the number of shares tendered by all shareholders;
- the prices at which those shareholders have tendered their shares; and
- whether any 'scale back' applies (see paragraph 3.89).

3.85 In a typical tender-style buyback, the documents will generally specify the approximate amount of capital that a company is prepared to return to its shareholders. Although the actual purchase price paid for a share (the 'buyback price') will not be determined until all tenders have been submitted and the buyback closes, the documents will, nevertheless, indicate the amount of the buyback price that the company will debit to its share capital account for each share bought back. The documents will also usually specify that the remainder of the buyback price will be treated for tax purposes as a dividend and be franked to a specified extent.

3.86 The actual buyback price will depend on shareholder demand under the tender process. The price will be one of the nominated tender prices, or a price based on one of the tender discounts. It will be the lowest price in the specified range at which there is sufficient shareholder demand for the company to return the amount of capital it has determined under the buyback.

3.87 Shareholders that tender their shares at a price above the buyback price will have their tenders rejected and the shares will not be bought back. Shareholders that tender their shares at or below the buyback price, or as a final price tender, will be successful and the shares will be bought back, subject to any 'scale back'. All shareholders successfully bidding will receive the same price.

3.88 Tender price ranges put forward by companies generally have a lowest price point at a significant discount to the prevailing ASX price immediately before the buyback announcement. These arrangements generally result in a buyback price which is at or close to the bottom end of the range.

3.89 A scale back arises where there is an excess of tenders. This will arise 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 will be 'scaled back' on a pro-rata basis among shareholders. However, the scale back will usually operate subject to 'priority allocations' and 'small holding allocations'. Priority allocations ensure that the company will buy 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 will have all their shares bought back.

INTERNATIONAL TREATMENT OF SHARE BUYBACKS

3.90 As noted in Chapter 2, in assessing the efficiency of Australia's taxation treatment of off-market share buybacks, it is necessary to consider them in the context of international approaches. If Australia's taxation treatment is less generous or flexible than that of other countries, this could reduce the competitiveness of our companies operating in international markets and the attractiveness of their shares to international investors. It could also to some degree reduce the attractiveness of Australia as a location for companies by increasing the cost of raising capital in our markets. However, international competitiveness needs to be considered in the context of our domestic revenue raising requirements.

3.91 It is difficult to make comparisons between the treatment of share buybacks in other countries under both corporations and taxation law as they depend significantly on the broader features of those laws. In particular, Australia's taxation treatment of share buybacks is driven in large part by our imputation system which is unique to Australia. While a number of countries have shareholder relief systems (including credit systems like Australia's) to reduce the double taxation of corporate income, the Australian system is the only one that provides for the refund of excess credits.

3.92 Similarly, capital gains are taxed in many different ways around the world. New Zealand does not impose CGT and of those countries that have a CGT regime some have a 'stepped rate' (as the holding period increases the tax rate decreases), some have a flat rate and others (such as Australia and Canada) use a discount system for taxing capital gains (only a proportion of the gain is taxable).[48]

3.93 There are also differences in how buybacks themselves are treated for both corporations law and tax purposes across countries.[49] For example, in the United States on-market and off-market purchases are treated in the same way with a distinction made between whether payment is in exchange for shares or a dividend. There are rules for determining the nature of the payment. In the United Kingdom on-market and off-market purchases are treated in the same way, with the purchase price being treated as a dividend except in so far as it represents repayment of share capital (see Appendix E for further details).

---

48 Tables 6.1.1 and 6.2.1 in the International Comparison of Australia's Taxes of 3 April 2006 show the differences in integration of company and individual tax and capital gains taxation, respectively, across ten OECD countries, see pages 215-222.

49 Dharmawan, GV and Mitchell, JD 2001, '*Australian buyback regulations – A cross-country comparison*' 12 *Australian Journal of Corporate Law* 246.

3.94 It is also necessary to consider how the taxation arrangements for share buybacks compare with alternative mechanisms for returning capital or profits to shareholders in those jurisdictions. If taxation arrangements favour a particular approach, this may distort decisions as to the form that is used. For example, in the United States, prior to 2003, dividends were taxed more heavily than capital gains and to the extent that share repurchases were treated as capital, they were likely to be more attractive to shareholders than dividends (changes have since been made to the taxation arrangements and the current taxation treatment of dividends and capital gains in the United States is summarised in Appendix G). There is some empirical evidence to support this view which shows that in the United States prior to 2003 share repurchases were used by companies as a substitute for the payment of ordinary dividends.[50] Similar analysis in Australia does not support the substitution hypothesis as a result of our dividend imputation system. What this analysis suggests is that the use of these mechanisms is highly sensitive to the taxation arrangements, both absolutely and relatively.

3.95 Market conditions and practices also vary from country to country, with tender processes being used in some countries for both on- and off-market purchases. Chapter 2 notes some of the factors that may be behind the increasing use of off-market share buybacks in Australia. Not all of these may be applicable to other countries. Other features may also be relevant. For example, for dual-listed companies such as BHP Billiton and Rio Tinto, share prices may vary between the markets on which they are listed.[51] Again, this could influence the market in which they choose to return capital and the way in which they do so.

---

50 Brown, C and O'Day J 2006, '*The Relationship Between Share Repurchases and Dividends in an Imputation Tax Environment*', Working paper.

51 For example, BHP Billiton in the UK trades at a discount to the price in the Australian market.

CHAPTER 4: IMPLICATIONS OF CURRENT TREATMENT OF OFF-MARKET SHARE BUYBACKS

FOR PUBLIC COMPANIES

Taxation implications

4.1 As noted in Chapter 3, from a company's perspective a share buyback, because it results in the cancellation of shares, has no income tax or CGT consequences. For both on- and off-market share buybacks there can, however, be franking account implications.

Increase in earnings per share (EPS)

4.2 A buyback may also result in an increase in earnings per share as there are fewer shares on issue following the buyback.[52] This effect is amplified by the discount at which companies are able to buy back shares under tender processes, enabling companies to buy back more shares for the same cost than in an on-market purchase. Special dividends and on-market purchases may not have such a significant impact on a company's earnings per share, particularly as on-market purchases may have an upward impact on the company's share price unless they are conducted over a significant period of time. An increase in earnings per share will benefit both the company and those shareholders who do not participate in the buyback.

4.3 Some argue that buybacks will not result in an increase in EPS. It is noted that as the company is spending money to buy back shares, investors will adjust their valuations to reflect the reduction in cash and shares, cancelling out any EPS effect. The actual effect of a buyback on EPS depends on a number of factors including the opportunity cost of the funds used to finance the buyback. Another key issue is the extent to which any increases in EPS are temporary or are sustained over time.

4.4 Analysis of the EPS outcomes for the companies that conducted buybacks listed in Appendix B (excluding Lemarne Group which had an increase of over 800 per cent in reported EPS) indicates an average increase in EPS of around 2.5 per cent in the year after the buyback; however 37 per cent of the companies experienced a decrease in EPS

---

52 $\text{EPS} = \dfrac{\text{Company's net income}}{\text{Number of shares on issue}}$

in the subsequent year.[53] Many other factors will influence a company's EPS and it is difficult to isolate the impact of a buyback.

4.5 To the extent that the market focuses on EPS because it forms the basis of a multiples approach to valuation, there may be some value in a company attempting to increase EPS through a buyback. However, it does not necessarily follow that the share price will increase. For example, a company that had idle cash on the balance sheet may experience an increase in EPS, but this may not make shareholders better off. An increase in EPS that is not the result of operating economies or underlying growth may increase the share price temporarily, but the increase is unlikely to be permanent.

Q4.1 Do off-market share buybacks generally result in more than a short-term increase in earnings per share? If so, for how long?

Q4.2 If so, is this beneficial, and to whom? Or are other measures, such as share prices, more important for shareholders?

Facilitating capital management

4.6 Buybacks are said to assist companies in managing their capital to achieve an appropriate balance between debt and equity. Whether buybacks are being used to reduce equity can be tested by looking at equity levels after the buyback has been completed. While for some companies, such as Seven Network Ltd and Woolworths, there have been reductions in the number of shares outstanding following buybacks, for other companies, including Westpac and the Commonwealth Bank, this does not appear to be the case possibly due to additional shares being issued through dividend reinvestment plans and employee share schemes. (This analysis is included in Appendix F.) In addition some companies are borrowing to provide part of the funding for off-market share buybacks.

Q4.3 Do off-market share buybacks facilitate capital management strategies?

Q4.4 If so, are they more effective than other mechanisms for doing so, and why?

Timing

4.7 Although companies generally seek Tax Office rulings before conducting off-market share buybacks, it has been argued that such buybacks can be conducted more quickly than on-market purchases because they are not dependent on the

53 Based on EPS figures from annual reports before and after the buyback.

company's liquidity on the ASX. Once Tax Office approval has been obtained, the companies listed in Appendix B generally completed the off-market share buyback in 47 days.[54]

Flexibility

4.8 Off-market share buybacks tend to be used by companies to distribute profits in preference to dividends when profits are volatile. Companies prefer to maintain a consistent dividend policy and avoid volatility in dividend payments. There is generally an expectation in the market that any increase in dividends will be maintained. As noted in paragraph 5.43, it appears that off-market share buybacks are not being used as a substitute for ordinary dividends, but are being used to distribute returns over and above ordinary dividend policy.

4.9 An alternative to off-market share buybacks to distribute volatile profits would be for companies to use special dividends. Special dividends will not have the same impact on EPS as a buyback. However, they do facilitate the distribution of franking credits, although they will be distributed to all shareholders. It appears that off-market share buybacks are preferred over special dividends.

Q4.5 Are there other implications for public companies, particularly when compared with other capital management strategies?

Q4.6 Why are off-market share buybacks preferred over special dividends for the distribution of volatile profits?

For different shareholders in listed companies

4.10 The tender process for off-market share buybacks when combined with the current taxation treatment means that the buyback has different implications for shareholders in listed companies on differing marginal tax rates. While this is in part a natural consequence of differences in marginal tax rates, the impacts are magnified by other elements of the tax arrangements, particularly when compared with the key alternative in the listed company situation, an on-market buyback. The deemed dividend and attached franking credits and the potential capital loss both drive this outcome. This is illustrated by comparing the tax treatment of on- and off-market share buybacks from the perspective of different kinds of shareholders in a stylised example in Table 4.1.

54 LMC and SOF are excluded from calculation of the average. Lemarne Corp took 157 and 242 days, while Software Communications took 272 days.

4.11 It is assumed that:

- The purchase price paid by the company for each share it bought back was $9 in the off-market share buyback and $10 in the on-market buyback.
- In the case of the off-market buy-back, the $9 purchase price was funded out of the company's share capital account ($2) and its profits ($7).
- The dividend component of the purchase price ($7) was fully franked (that is $3 of franking credits was allocated to the dividend).
- The amount that would have been the market value of a share at the time of the buyback, if the buyback did not occur and was never proposed to occur, was $10.

4.12 The following shareholders each sold one share under the buyback:

- A — a resident individual (subject to tax at the rate of 16.5 per cent, including Medicare levy);
- B — a resident individual (subject to tax at the rate of 46.5 per cent, including Medicare levy);
- S — a complying superannuation fund (subject to tax at the rate of 15 per cent);
- C — a resident company (subject to tax at the rate of 30 per cent);
- N — a non-resident (not carrying on business in Australia); and
- E — a tax exempt charity (which is eligible for refunds of franking credits) or an individual subject to a zero tax rate.

4.13 It is also assumed that the shareholders acquired their shares in the company two years ago for $5 each and that they held their shares on 'capital account'.

Table 4.1: Taxation effects of off- and on-market share buybacks
Off-market share buyback

Off-market share buyback for $9	**A (16.5%)**	**B (46.5%)**	**S (15%)**	**C (30%)**	**N**	**E**
Taxation of dividend						
Assessable dividend[(a)]	$7.00	$7.00	$7.00	$7.00	Nil	Nil
Franking gross-up	$3.00	$3.00	$3.00	$3.00	Nil	Nil
Taxable income	$10.00	$10.00	$10.00	$10.00	Nil	Nil
Income tax before any credit	$1.65	$4.65	$1.50	$3.00	Nil	Nil
Less franking credit	$3.00	$3.00	$3.00	$3.00	Nil	$3.00
Income tax payable (or refund)	($1.35)	$1.65	($1.50)	Nil	Nil	($3.00)
CGT treatment on sale of share						
Capital proceeds[(b)]	$3.00	$3.00	$3.00	$5.00	N/A	N/A
Cost base	$5.00	$5.00	$5.00	$5.00	N/A	N/A
Capital loss before discount	$2.00	$2.00	$2.00	Nil	N/A	N/A
Less discount (50% for A and B, 33⅓% for S)	$1.00	$1.00	$0.67	Nil	N/A	N/A
Capital loss after discount	$1.00	$1.00	$1.33	Nil	N/A	N/A
Shareholders' after-tax position						
Purchase price received for sale of share	$9.00	$9.00	$9.00	$9.00	$9.00	$9.00
Plus refund (or less income tax)	$1.35	($1.65)	$1.50	Nil	N/A	$3.00
Plus value of capital loss[(c)]	$0.165	$0.465	$0.20	Nil	N/A	N/A
Net after-tax return[(d)]	$10.515	$7.815	$10.70	$9.00	$9.00	$12.00
Return on investment	110.3%	56.3%	114%	80%	80%	140%

Table 4.1: Taxation effects of off- and on-market share buybacks (continued)
On-market buyback

On-market share buyback for $10	A (16.5%)	B (46.5%)	S (15%)	C (30%)	N	E
CGT treatment on sale of share						
Capital proceeds (section 159GZZZQ)	$10.00	$10.00	$10.00	$10.00	N/A	N/A
Cost base	$5.00	$5.00	$5.00	$5.00	N/A	N/A
Capital gain before any discount	$5.00	$5.00	$5.00	$5.00	N/A	N/A
Less discount (50% for A and B, 33⅓% for S)	$2.50	$2.50	$1.67	Nil	N/A	N/A
Capital gain after discount	$2.50	$2.50	$3.33	$5.00	N/A	N/A
Tax on capital gain after discount	0.41	$1.16	$0.50	$1.50	N/A	N/A
Shareholders' after-tax position						
Purchase price received for sale of share	$10.00	$10.00	$10.00	$10.00	$10.00	$10.00
Less tax on capital gain	0.41	$1.16	$0.50	$1.50	N/A	N/A
Net after-tax return(d)	$9.59	$8.84	$9.50	$8.50	$10.00	$10.00
Return on investment	91.8%	76.8%	90%	70%	100%	100%

Notes
(a) The dividend is $7, being the difference between the purchase price ($9) and the amount debited to the company's share capital account ($2) (s 159GZZZP).
(b) The consideration is calculated under s 159GZZZQ as follows:
- Consideration = purchase price + market value uplift amount – reduction amount
- The 'purchase price' is $9 (s 159GZZZQ(1)).
- The 'market value uplift amount' is $1, being the amount by which the market value of the share ($10) exceeds the purchase price ($9) (s 159GZZZQ(2)).
- For all shareholders other than C, the 'reduction amount' is $7, being the amount of the dividend (s 159GZZZQ(3), (4)). In the case of C, however, the $7 amount is reduced by $2 so that the reduction amount is only $5 (s 159GZZZQ(8)). The $2 reduction is so much of the 'offsetable amount' ($10) as does not exceed the 'loss amount' ($2). The 'offsetable amount' is calculated as the amount of the tax offset on the dividend ($3) divided by the corporate tax rate (30 per cent) (s 159GZZZQ(9)).

(c) The 'value of the capital loss' is calculated by multiplying the taxpayer's capital loss by the taxpayer's tax rate. It assumes that the capital loss is able to be set off against capital gains.
(d) Note that N's net after-tax return may be affected by foreign tax payable in N's country of residence.

4.14 Table 4.1 shows that certain shareholders are more likely than others to participate in off-market share buybacks. In particular, tax exempt charities and shareholders who pay tax at rates below the corporate tax rate (such as resident individuals on low marginal tax rates and complying superannuation funds) will be better off selling shares in an off-market share buyback than on-market. As they are able to benefit from refundable franking credits allocated to the dividend component of the purchase price and may also generate losses on the disposal of their shares, these shareholders are often better off selling their shares under an off-market share buyback at prices below market value than selling their shares on-market.

4.15 Off-market share buybacks are even more attractive to shareholders where they are able to use capital losses without facing a CGT discount. This can be the case for superannuation funds and individual taxpayers where they are able to offset a capital loss against capital gains on assets held for less than 12 months. Off-market share buybacks are not as attractive to companies as they may not able to fully to utilise the capital loss. However, buybacks offering fully franked dividends can still be attractive to taxpayers facing marginal tax rates below 30 per cent even if they cannot use any part of a capital loss.

4.16 Another benefit to participating shareholders is that they do not have to pay brokerage for the off-market sale of shares back to the company, whereas in an on-market buyback brokerage would be payable.

4.17 In contrast, both high-rate shareholders and non-resident shareholders are better off selling their shares at full value on-market. Non-resident shareholders cannot benefit from franking credits allocated to franked dividends and high-rate resident individual shareholders have to pay additional tax on such dividends. High-rate shareholders may also prefer to make capital gains on the sale of their shares instead of receiving dividends, as they may be able to benefit from the CGT discount (assuming they have held their shares for at least 12 months).

4.18 The key factors influencing the outcome for different types of shareholders are the sale price (whether at a discount or premium to market price) and the division of that price between capital and deemed dividend. Appendix G contains a model that calculates the break-even combinations of discounts, capital and dividends for particular classes of shareholders. This model shows that:

- it is not beneficial for individuals on high marginal tax rates to participate in an off-market share buyback unless the company is buying back the shares at a price *above* the market price, which is unlikely; and
- it is beneficial for superannuation funds and charities to participate in off-market share buybacks at a price *below* the market price, providing the dividend component is sufficiently large.

Non-participating shareholders

4.19 Shareholders who do not participate in off-market share buybacks may, nevertheless, indirectly benefit from them through increased earnings per share as discussed in paragraphs 4.3 to 4.6. They may also experience an increase in the market value of their shares. This is because the company has bought back shares at a discount to market value. Since less than market value consideration has left the company when it purchased the shares, the market value of the remaining shares may increase to reflect this.

4.20 However, companies will have fewer franking credits available to distribute to non-participating shareholders in the future. Whether this is a disadvantage to non-participating shareholders depends on the value attached to those franking credits, which turns in large part on the extent to which it reduces the company's ability to pay franked dividends in the future. This is discussed in further detail in Chapter 5.

Role of fund managers

4.21 While it has been claimed that superannuation funds are significant participants in off-market share buybacks, most funds (other than self-managed funds) employ a fund manager to invest funds on their behalf. The performance of many fund managers is measured on a pre-tax basis. As a result, there may be an adverse impact on their market rating when they participate in tender-style off-market share buybacks on behalf of their clients. This occurs because the sale of shares at a discount to market price impacts on their pre-tax performance.

For employees under employee share schemes

4.22 As noted in Chapter 2, selective off-market share buybacks may be used by unlisted companies in particular to buy back shares held under employee share schemes. In some circumstances, the taxation outcome for employee shareholders will be the same as for other shareholders. However, where Division 13A of the ITAA-1936 applies to the shares, to tax the benefit of the discount on shares acquired under an employee share scheme, the tax outcome for employees can vary significantly. The deemed dividend component is excluded from the sale proceeds for the purposes of determining the assessable amount under Division 13A.[55] As a result, whether or not an employee shareholder pays more or less tax in a buyback of employee shares than would have otherwise been payable if the shares had been sold to a third party will depend on the amount paid by the employee for the shares, the extent to which the deemed dividend component of the buyback is franked, and the employee shareholder's tax rate. Appendix H outlines a number of examples highlighting some of those different tax outcomes.

Q4.7 Does the interaction between the provisions for taxation of off-market share buybacks and employee share schemes work appropriately?

Q4.8 If not, why, and what changes could be made to ensure a more appropriate interaction?

55 By virtue of the general application of ITAA 1936, subsection 159GZZZQ(3).

FOR SHAREHOLDERS IN UNLISTED COMPANIES

4.23 As noted in Chapter 2, closely held unlisted companies, whose shareholders are predominantly the original subscribers to the company, tend to use off-market share buybacks to restructure businesses in instances where the company is buying back shares of those original shareholders that are no longer continuing in the business. Such companies are not using the tender arrangements described in paragraph 3.82.

4.24 The tax issues for shareholders in such situations differ from those for shareholders in listed companies outlined above. In particular:

- the exiting shareholders may not make a capital loss as the capital component of the original acquisition is generally recouped in full;
- the parties are at arm's length and in the absence of an organised market for the shares, they arrive at that price on the basis of what they are prepared to accept and/or pay;
- there is no capital benefit; and
- there is unlikely to be any franking credit streaming or franking benefits as the shareholders are generally taxable Australian entities subject to personal and corporate tax rates.

4.25 As a result, the implications of the current treatment of off-market share buybacks for closely held unlisted companies are very different from those for listed companies. However, widely held unlisted companies may be in a similar position to listed companies.

4.26 The alternatives to off-market share buybacks for unlisted companies in achieving their corporate restructuring goals are selective capital reductions and purchase by the continuing shareholders rather than the company. Generally the taxation outcomes for the exiting shareholder are almost the same regardless of the option chosen.[56]

4.27 The key issues for unlisted companies may be the ease with which they can apply the current provisions in relation to off-market share buybacks and whether the provisions impose unnecessary compliance costs on them.

4.28 As a result, it may be necessary to distinguish between listed and unlisted companies in considering changes to the current arrangements. However, some of the considerations applying to listed companies could equally apply to widely held

---

56 In instances where the capital gain arising from the sale of shares to the continuing shareholders is equivalent to the deemed dividend arising from a buyback or capital reduction.

unlisted companies. Different considerations may also apply in the case of self-managed superannuation funds.

Q4.9 Are there other implications of the current treatment of off-market share buybacks for unlisted companies and their shareholders?

Q4.10 Are the current provisions easy for unlisted companies to understand and comply with? If not, what changes could be made to reduce compliance costs for unlisted companies?

Q4.11 Do unlisted companies have difficulties in calculating the market value? If so, what might be some approaches for dealing with these difficulties?

Q4.12 Should there be different taxation arrangements for off-market share buybacks for listed and unlisted companies?

Q4.13 Should the current arrangements be retained for unlisted companies, with any changes being made for listed companies only?

Q4.14 Are there circumstances in which listed companies should be treated in the same way as unlisted companies?

Q4.15 How should widely held unlisted companies be dealt with?

Q4.16 Would separate regimes increase compliance and administration costs?

FOR THE TAXATION REVENUE

4.29 By facilitating the distribution of franking credits to those shareholders who are able to make the greatest use of them, off-market share buybacks avoid the wastage of franking credits that would otherwise typically occur under equal distribution patterns. This is regarded as a 'tax expenditure' under the Tax Expenditures Statement.[57] In effect, it is a measure of the reduction in taxation revenue when compared with a benchmark of even distribution of franking credits. The tax expenditure is equal to the difference between the tax actually payable and the tax that would have been payable had the franking credits been evenly distributed among all

---

57 Commonwealth of Australia, '*Tax Expenditures Statement* 2006'.

shareholders. Table 4.2 sets out the latest estimates of the tax expenditure associated with off-market share buybacks.

Table 4.2: Tax expenditure arising from off-market share buybacks

2002-03	2003-04	2004-05	2005-06
$80m	$276m	$551m	$452m

4.30 The figures show a significant increase in the tax expenditure in 2003-04, when tender-style off-market share buybacks first began to be used, and in 2004-05, although it declined in 2005-06.

4.31 The tax expenditure does not measure the impact on taxation revenue as a result of an off-market share buyback. Rather, it is a measure of the aggregate benefit to taxpayers that arises because the actual taxation collections differ from those which would arise under the benchmark of an equal distribution across all shareholders. The precise impact of off-market share buybacks on taxation revenue is difficult to determine. In particular, tax expenditure estimates are calculated on a 'no behavioural change' basis which means that they tend to overstate the impact of tax concessions on revenue relative to estimates that allow for changes in the behaviour of taxpayers.

4.32 The tax expenditure does not take into account the capital loss that participating shareholders generally incur in relation to off-market share buybacks as it is consistent with the benchmark treatment. However, the level of capital losses incurred by taxpayers does not affect the revenue impact of off-market share buybacks because, as noted in paragraph 3.49, the capital losses prevent the double taxation of corporate income. The effect of concessions such as the capital gains tax discount is to reduce the revenue impact of off-market share buybacks and these are a major factor making off-market share buybacks unattractive to taxpayers on the top marginal rate.

4.33 The tax expenditure does not take account of the debit made to the franking account of the company under the anti-avoidance provisions. However, the extent to which this would impact on taxation revenue depends on whether the franking credits would otherwise have been distributed by companies to shareholders, or would have remained locked in the company's franking account.

4.34 Further, the actual impact of off-market share buybacks on taxation revenue may be reduced over time. Where the buyback results in an enhanced value of any remaining shares, there will be a higher CGT liability for non-participating shareholders who sell their shares. In addition, companies may distribute the funds they saved from being able to buy back their shares at a discount to remaining high-rate taxpayers or reinvest those funds to stimulate profit growth, which would generate additional company tax receipts and earnings that might be subsequently distributed to the remaining shareholders and taxed in their hands.

Compared with other mechanisms

4.35 The implications of the current treatment of off-market share buybacks need to be assessed against other mechanisms for achieving the same objectives. As noted in Chapter 2, those objectives may differ between listed and unlisted companies. For unlisted companies and their shareholders the tax treatment of the various alternatives, capital reductions or sale to continuing shareholders, are broadly the same. The key difference is the process.

4.36 For listed companies, the other mechanisms are on-market buybacks, dividends and capital reductions. The objective being sought will influence the mechanism chosen. Table 4.3 gives an indication of the possible effects of these different types of mechanisms.

Table 4.3: Effects of different mechanisms on company and shareholders

	Partial return of capital[(a)]	Off-market share buyback	On-market buyback	Increase in ordinary dividend	Special dividend
Signalling effects on announcement	?	Positive on average	Positive on average	Positive on average	?
Number of shares outstanding	No change	Decrease	Decrease	No change	No change
Aggregate market value of shares	Decrease	Decrease	Decrease	Decrease	Decrease
Market value per share	Decrease	Increase	No change (ignoring signalling effects)	Decrease	Decrease
Transfer of wealth between participating and non-participating shareholders?	No	Not necessarily	No (assuming the company has no market timing ability)	No	No
Ability to distribute franking credits	No	Yes	No	Yes	Yes
Ability to stream franking credits	No	Yes	No	No	No

(a) A capital reduction not involving the cancellation of shares

CHAPTER 5: ASSESSMENT OF CURRENT TAXATION TREATMENT

INTRODUCTION

5.1 This Chapter considers the outcomes of the current arrangements for off-market share buybacks against the policy objectives outlined in Chapter 2 of efficiency, equity and simplicity. In doing so, it also explores some of the issues and concerns that arise with the current arrangements.

5.2 As Chapter 4 notes, there are clearly advantages for companies and participating shareholders in off-market share buybacks. There may also be advantages for the economy more broadly and for non-participating shareholders, although this is explored in greater detail below. However, those advantages come at a cost to the taxation revenue and may give rise to some equity issues, and the provisions may give rise to unnecessary compliance costs and uncertainty for taxpayers and administration costs for the Tax Office. The key issue is whether the advantages of the current arrangements for off-market share buybacks are significant enough to outweigh the potential disadvantages and whether there are ways in which any potential disadvantages could be ameliorated. It is also important to consider the opportunity cost of the cost to taxation revenue. Even if the benefits of off-market share buybacks do outweigh the costs, there may be other ways of deriving greater benefits for the same costs. In addition, the policy objectives are not mutually exclusive and may need to be balanced in any assessment of the appropriate taxation arrangements for off-market share buybacks.

5.3 Without forming a view on where the balance of the policy objectives lies, as this is a key issue for consultation, this Chapter also identifies possible ways of addressing the issues and concerns raised with the current arrangements. They should not be seen as a package of options that could form the basis of recommendations. Rather, they are a collection of ideas on which the Board seeks comment. This will assist the Board in forming its recommendations to government.

EFFICIENCY/NEUTRALITY

5.4 A key issue is whether off-market share buybacks provide broader economic benefits and whether they do so in a more efficient way than other possible mechanisms for achieving those benefits.

5.5 As noted in Chapter 4, the current arrangements provide companies with a fast and efficient means to distribute both excess cash and excess franking credits to the group of shareholders who find it beneficial to participate. In addition, off-market share buybacks provide companies with a mechanism to manage their capital structure efficiently. Just as companies have a range of methods to raise equity capital when needed, off-market share buybacks provide companies with a mechanism to shrink the equity base. This is particularly important when companies enter the mature stage of their life-cycle and the investment opportunity set is contracting.

5.6 The added flexibility provided by off-market share buybacks in managing company balance sheets may bring about more efficient capital allocation within the company and efficient allocation of resources in capital markets more broadly. Whether off-market share buybacks provide a benefit to the capital markets/economy is difficult to determine and can only be assessed by considering a number of different measures.

Better allocation of resources

5.7 One way in which an off-market share buyback could result in economy-wide benefits is if the cash distributed to shareholders is applied to more productive uses than it would have been if it had been retained in the company. It may also result in managers being motivated to run the company more efficiently.[58]

5.8 The issue to consider is whether companies are in fact using off-market share buybacks as a mechanism to distribute excess cash. One way of assessing this is to look at the relationship between the dollar value of shares repurchased and excess cash.[59] Figure 5.1 shows a positive relationship between excess cash in the previous financial year and the dollars spent on off-market share buybacks. There are other factors that might affect the volume repurchased (variables such as size, leverage, institutional ownership, market-to-book ratio). However, this analysis provides some support for the idea that firms are returning surplus cash to shareholders.

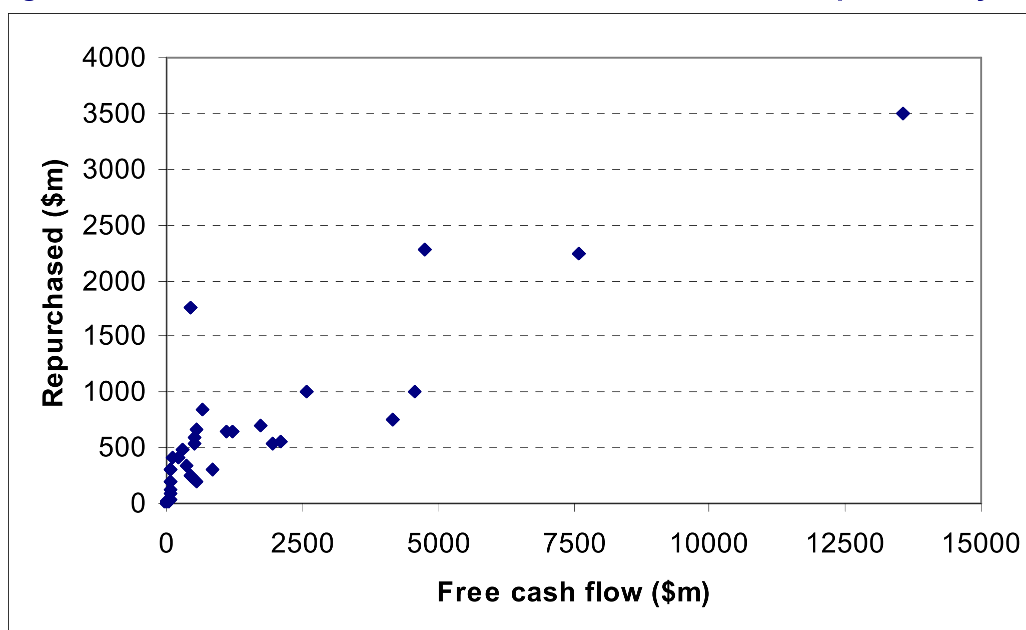
5.9 The positive abnormal returns on announcement of the buyback shown in Figure 5.2 are also consistent with this view. One interpretation of the positive market response is that the discipline imposed on managers as a result of returning excess cash to shareholders is seen as beneficial and the market reacts favourably to the news.

---

58 In finance literature this is known as the free cash flow hypothesis.

59 To do this analysis a measure of free cash flow is calculated from the annual report data immediately prior to the announcement of the off-market repurchase. Data is collected from Aspect Huntley FinAnalysis.

Figure 5.1: The relation between free cash flow and dollars spent in buyback



Source: Brown, C, 2007 '*Off-Market Share Repurchases in Australia'*, Working paper.

5.10 However, finding evidence to support the idea that companies are using off-market share buybacks to distribute cash in excess of the needs of their dividend and investment policy, does not preclude there being other more efficient or equitable ways of returning the excess cash to shareholders. In addition, there may be other ways of achieving greater capital market efficiency that are more equitable or less costly.

Q5.1 Do off-market share buybacks lead to efficient economic outcomes?

Q5.2 If so, do they do so more efficiently than other mechanisms for returning surplus cash?

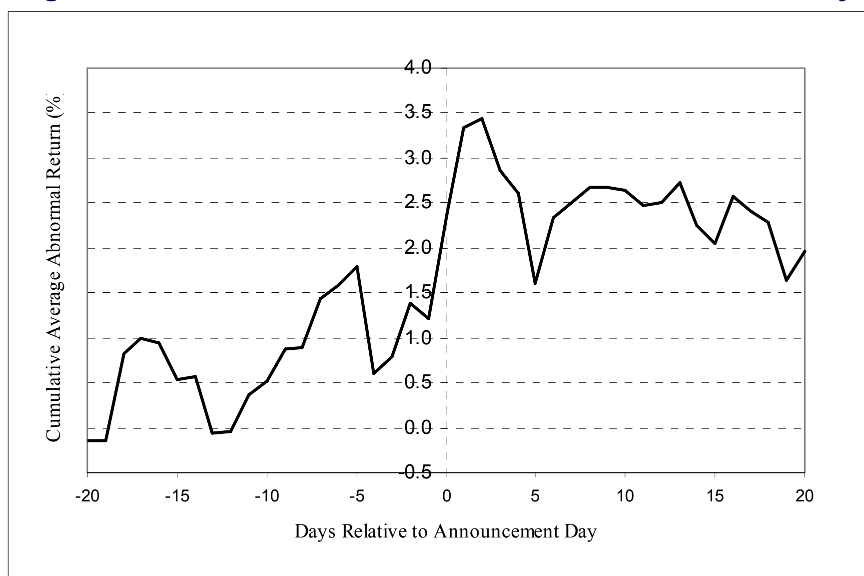
Q5.3 Why are they more efficient?

Q5.4 To what extent do the current taxation arrangements drive this outcome? Could the efficiencies be achieved without the current tax arrangements?

Off-market share buybacks, tax effects and announcement effects[60]

5.11 Another measure of the possible broader benefits of off-market share buybacks is the way in which the market reacts to the announcement of the buyback. As Figure 5.2 shows, it appears that on average, investors think that buybacks are beneficial.[61] This positive response seems to suggest that there are benefits to the market as a whole as a result of the buyback.

Figure 5.2: Abnormal returns around the announcement day[62]



Source: Brown, C, 2007 '*The Announcement Effects of Off-Market Share Repurchases in Australia'* Australian Journal of Management, forthcoming.

5.12 Further analysis of these figures indicates that there is a strong relationship between the share price response and the market reaction to the announcement of the buyback. As the degree to which the share price is discounted is facilitated by the ability of the company to provide franking credits to participating shareholders, this suggests that the current taxation treatment plays an important role in the market reaction. (See Appendix I for further details.)

5.13 Under current arrangements for off-market share buybacks, companies with excess cash can buy back shares at a price below the market value: this is a higher

---

60 The results quoted in this section are based on Brown, C, 2007 '*The Announcement Effects of Off-Market Share Repurchases in Australia'* Australian Journal of Management, forthcoming.

61 Figure 5.2 charts the average share price response around the buyback announcement date (by calculating for each company announcing a buyback how its stock price changed relative to the market index) from 20 days prior to 20 days after the announcement of the buyback. Day 0 is the announcement day.

62 In Figure 5.2 the cumulative average abnormal return for companies announcing buybacks from 1997 to 2003 (which were generally at a fixed price) is calculated around the buyback announcement date which is day zero. This figure is created from buybacks listed in Appendix B up until the end of 2003. This data is prior to changes in the way in which the capital gains tax is calculated for shareholders participating in an equal access repurchase. See paragraph 3.23.

returning investment for the company than retaining the cash. Current off-market share buyback activity appears to be related to the level of free cash flow for companies, and the current tax arrangements provide companies with a mechanism to generate positive returns when investment opportunities are declining.

5.14 Other mechanisms for distributing cash to shareholders include ordinary dividends, special dividends, return of capital, and on-market buybacks. However, none of these methods provides a return for the company in the same way as an off-market share buyback. These methods have differing tax consequences for shareholders receiving the cash. Possible tax and other effects of the alternative cash disbursement methods were summarised in Table 4.3.

International competitiveness

5.15 As noted in Chapter 2, another key consideration in an efficiency context is the extent to which Australia's arrangements for off-market share buybacks are more or less favourable than those applying in other countries. Chapter 3 notes the difficulties of international comparisons in this area. What is clear from that analysis is the importance of taxation arrangements in the choice of capital management strategies for companies and the uniqueness of our imputation system. The Board will be mindful of these considerations in framing its recommendations to government.

Q5.5 How do Australia's taxation arrangements for off-market share buybacks compare with those of our key trading partners? Are they more or less generous?

Q5.6 Would changes to our taxation arrangements reduce the competitiveness of our companies operating in international markets or make Australia a less attractive location for corporate operations? If so, how significant are the effects likely to be?

Q5.7 Are there other ways of addressing international competitiveness?

Optimal use of franking credits

5.16 It has also been argued that off-market share buybacks are an efficient mechanism for making optimal use of franking credits. They enable companies to distribute franking credits to those shareholders who are best able to use them and avoid them being wasted on shareholders who cannot use them. As noted in Chapter 2, over the last 10 years or so, off-market share buybacks have enabled companies to distribute $7.3 billion of franking credits to shareholders. However, as outlined in Chapter 4, they are likely to do so at a cost to taxation revenue.

5.17 In addition, the general policy underlying the imputation system is that over time franking credits should be spread more or less evenly across shareholders in

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

5.18 The significant scale-back in many recent off-market share buybacks may be indicative of the demand for franking credits by those who are best able to use them.

5.19 Other mechanisms for distributing cash do not provide the same opportunities to distinguish between types of shareholders in distributing franking credits. In particular, dividends are payable to all shareholders holding a particular class of shares and companies are not able to target particular shareholders in on-market buybacks.

5.20 Payment of the excess cash via ordinary or special dividends would result in an equitable distribution of the cash to all shareholders. However, because foreign shareholders are unable to use franking credits, some have argued that the result would be a sub-optimal use of the imputation tax credits. To the extent that there is some wastage of franking credits because of foreign ownership, distribution of franking credits via off-market share buybacks targets franking credits to resident investors and increases the overall usage of imputation tax credits. As noted, this is inconsistent with the policy underlying the imputation system.

5.21 The average use of distributed franking credits increased from 67 per cent over 1990-2000 to 81 per cent over 2001-2004.[63] Some of this increase in franking credit utilisation can be partly explained by the introduction of refunds of franking credit in July 2000. Franking credits claimed over 2001-2004 averaged $7.4 billion per year. The off-market share buybacks listed in Appendix B over the years 2001-2004 average $602.3 million of franking credits distributed per year, just over 8 per cent of the franking credits utilised over those years. Clearly, off-market share buybacks have also had some impact on utilisation.

63 Handley, J and Maheswaran, K 2007, '*A Measure of the Efficacy of the Australian Imputation Tax System*' unpublished.

Q5.8 Is it appropriate that off-market share buybacks enable the optimal use of franking credits?

Q5.9 How does this impact on the underlying policy of the imputation system of equal distribution of franking credits over time? In particular, what are the likely impacts on taxation revenue?

Distortions between different mechanisms

5.22 Differences in the taxation treatment of the various mechanisms for returning funds to shareholders can create distortions in choices, which of themselves can have an adverse impact on the efficiency of the economy. If the view was taken that these distortions were adversely impacting on economic efficiency, they could be addressed by aligning the tax treatment of these mechanisms. The key alternative mechanisms for listed companies are special dividends and on-market buybacks. Aligning the taxation treatment with special dividends would see all the buyback consideration treated as a dividend. Alternatively, the tax treatment of off-market and on-market buybacks for listed companies could be aligned. However, this is difficult to achieve given the differing taxation treatments of dividends and capital gains. Possible partial approaches are discussed below. Alignment with either special dividends or on-market share buybacks may not be an appropriate outcome for unlisted companies.

Include franking credits in the calculation of market value

5.23 The tax benefit arising from an off-market share buyback could be addressed by requiring companies, when determining the total buyback consideration for comparison with the market value of shares, as set out in the tax determination, to use the grossed-up value of the dividends rather than the cash value (that is, including the value of the franking credits). Off-market share buybacks would become tax neutral relative to on-market buybacks for taxpayers who do not receive the CGT discount and have capital gains to absorb capital losses. However, this would make off-market share buybacks less attractive than on-market buybacks for taxpayers who receive the CGT discount or cannot utilise capital losses.

Deny companies the ability to frank the dividend component

5.24 Another avenue for addressing the tax benefit of off-market share buybacks would be to deny companies the ability to frank the dividend component. This would provide tax neutrality between off-market and on-market share buybacks with an equivalent market valuation for taxpayers who are taxed on the full value of capital gains and can utilise capital losses, but would make off-market share buybacks unattractive to shareholders who receive the CGT discount or cannot utilise capital losses.

5.25 A consequence of this would be that companies would accumulate franking credits. Other mechanisms for the streaming of franking credits might emerge.

5.26 To achieve tax neutrality between off-market and on-market share buybacks for shareholders who receive the CGT discount would require not only one of these approaches, but also the tax on the grossed-up dividends under the off-market share buyback to be discounted by the CGT discount as well. This would be contrary to the policy behind the introduction of the CGT discount and create a significant extension of the CGT discount.

Q5.10 What are the advantages and disadvantages of these approaches?

Q5.11 Are there other ways of reducing or eliminating the tax benefits associated with off-market share buybacks?

Q5.12 If there is not a separate regime for unlisted companies, what would the implication of these approaches be for those companies?

EQUITY

5.27 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 participating shareholders receive benefits at the expense of non-participating shareholders and at a cost to the taxation revenue. As noted in Chapter 4, the combination of current legislative arrangements and market practices means that generally low-rate shareholders or tax exempt charities are likely to participate in off-market share buybacks, while non-resident and higher rate shareholders are unlikely to participate. The opposing view is that non-participating shareholders receive other non-taxation benefits and that the general taxpaying community benefits from the greater capital market efficiency arising from off-market share buybacks.

5.28 The equity concern has a number of dimensions arising from consideration of both the Corporations Act and the taxation law. In relation to the Corporations Act it is noted that section 254W specifies that each share in a class of shares in a public company has the same dividend rights unless the company's constitution provides for the shares to have different dividend rights or different dividend rights are provided for by special resolution of the company. It is argued that the retained tax-paid profits of a company and the franking credits that are notionally attached to them, belong to all shareholders equally and 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.

5.29 However, ASIC has indicated[64] 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. 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.

5.30 ASIC also notes that it is the directors of a company who must be satisfied that, even though a buyback with a deemed dividend component results in only low-rate shareholders participating, 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.

5.31 While the Board's terms of reference allow it to take into account any matters that it considers appropriate, this review is fundamentally about the taxation arrangements for off-market share buybacks. As a result, although the Board is mindful of these arguments, it does not propose to consider them in detail as part of this review.

5.32 From a taxation perspective, it is argued that inequities can arise because the current arrangements facilitate the distribution of franking credits to certain classes of shareholders rather than all, contrary to the policy underlying the imputation system. Others argue that all shareholders are provided with an opportunity to participate, giving them the flexibility to determine the outcome that best suits their individual circumstances. It is also noted that the taxation outcomes are in part a reflection of our progressive income tax system and the decision to refund franking credits where the credits exceed tax payable.

5.33 To the extent that the current arrangements for off-market share buybacks result in benefits to lower tax rate shareholders, this may increase the vertical equity of the tax system. However, the lower rate shareholders who benefit from off-market share buybacks are not necessarily low-income earners. As Chapter 4 shows, those most likely to participate in an off-market share buyback are superannuation funds and tax exempt charities. In addition, it is not a very transparent mechanism for distributing benefits to particular classes of taxpayer.

5.34 Further, to the extent that the current taxation treatment comes at a cost to taxation revenue, there is a question of equitable outcomes between participating shareholders and the broader taxpaying community.

---

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

5.35 In addition, it has been argued that small shareholders get preferential treatment in a priority tender process. In cases where buybacks are oversubscribed and offers are scaled back, small shareholders are assured of selling all their shares. Others suggest that this is the only way to protect small shareholders. If priority allocations were not provided for, small shareholders could be scaled back to such a degree that they are left with odd parcels of shares that are uneconomical to sell due to brokerage charges.

Non-participating shareholders

5.36 A key issue for consideration in the equity context is whether non-participating shareholders receive benefits from the buyback that differ from those received by participating shareholders. While it is not possible to prove conclusively that non-participating shareholders are better off as a result of off-market share buybacks, there are a number of pieces of evidence that are relevant to the issue.

5.37 Shareholders have different characteristics, and buybacks may create value for all by targeting specific tax benefits to those best able to use them. There is a cost to participating shareholders in the form of the discount to market price that they receive for selling their shares. That discount provides benefits to the remaining shareholders, compensating them to some degree for the loss of franking credits.

5.38 Whether the benefit of the discount offsets the loss of franking credits can be empirically tested. Appendix J provides a model for making this assessment. This model does not take account of the impact of the buyback on the companies' share price and earnings per share, which is discussed further below.

5.39 The results are critically dependent on the value attached to franking credits. Empirical studies have led to conflicting results that place the value of franking credits at anything from close to unity to close to zero.[65] A recent study using Tax Office data shows that a reasonable estimate over the period 2001 to 2004 is 0.81.[66] Access pricing regulators (such as the ACCC) attempting to determine the cost of capital for regulated industries have tended to adopt a value of around 0.5.

5.40 If franking credits were valued at unity, the discount would not offset the loss of franking credits for non-participating shareholders. If franking credit valuation were 50 per cent the story is somewhat more mixed, but non-participating shareholders would still not be fully compensated in the majority of cases. Thus the implications for non-participating shareholders as a direct result of the off-market share buyback depends on the market valuation of undistributed franking credits.

---

65 Walker S and Partington, G 1999, '*The value of dividends: Evidence from cum-dividend trading in the ex-dividend period*', *Accounting and Finance*, 39, 275-296; Cannavan, D, Finn, F and Gray, S 2004, The value of dividend imputation tax credits in Australia' *Journal of Financial Economics* 73, 167-197.

66 Handley, J and Maheswaran, K 2007, '*A Measure of the Efficacy of the Australian Imputation Tax System*', unpublished.

5.41 The value attached to franking credits turns in large part on whether they would otherwise have been distributed to shareholders with dividends, now or at some time in the future. Where this is the case, the impact of the off-market share buyback has been to stream franking credits to participating shareholders at the expense of non-participating shareholders and the impact on tax revenue would be to defer rather than reduce total tax revenue.

5.42 This will not be the case where the company cannot fully use its franking credits, for instance because it does not fully distribute its taxable income as dividends or has insufficient accounting profit to use all the franking credits it receives and its franking credits become 'trapped'. In this case the franking credits are of limited value. An off-market share buyback in these circumstances would allow the company to distribute its surplus franking credits without reducing the extent of franking of future dividends and there would be a negative impact on tax revenue as a result.[67]

5.43 Empirical research in Australia suggests that companies are not using off-market share buybacks as a substitute for ordinary dividends, which implies that they are unlikely to be reducing their ability to pay out fully franked dividends in the future.[68] Instead it would seem to suggest that companies may not be fully distributing taxable income as dividends and buybacks are being used to disburse cash excess to the needs of ordinary dividend policy. In part, this may be because they see current increases in profit as temporary and do not want to create market expectations of more permanent increases in dividend payout rates. It is also consistent with evidence from management surveys which suggests that managers take the dividend payout level as given because of the market reaction to cuts in dividends.[69] However, special dividends may be another option.

5.44 Preliminary evidence also suggests that recent increases in cash disbursements through off-market share buybacks have been accompanied by dividend increases for some companies.[70] Figure 5.3, which shows the trends in payout activity over recent years in Australia, supports this view. In particular, while for the years 1996-2003 off-market share buybacks returned $12.1 billion to shareholders and on-market

---

67 It should be noted that companies that do buybacks where there are insufficient accounting profits to which franking credits are attached may end up with negative retained earnings (or accumulated losses).

68 Brown, C and O'Day, J 2005 '*The Dividend Substitution Hypothesis: Australian Evidence*', Working paper.

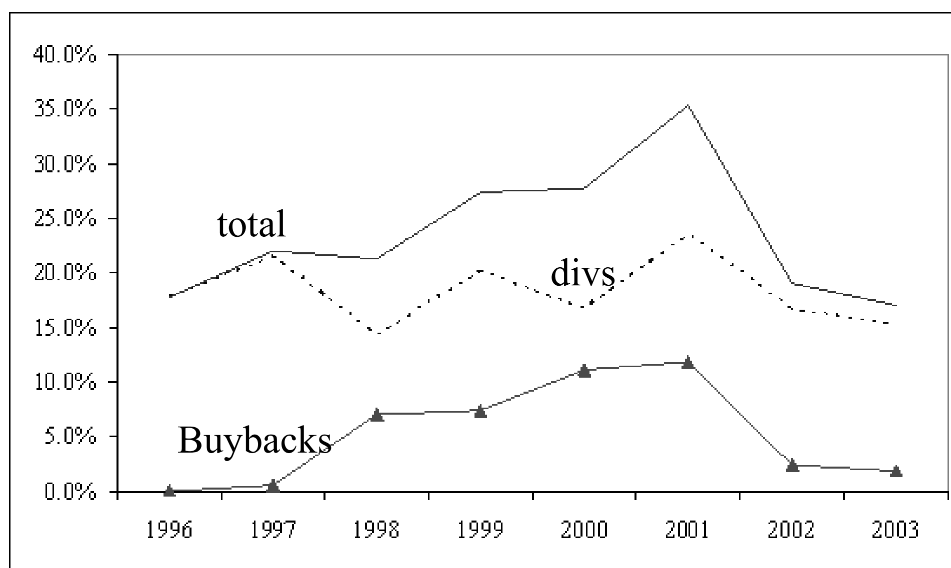
69 Brav, A, Graham J, Harvey C and Michaely, R 2005, 'Payout Policy in the 21st Century,' *Journal of Financial Economics* 77, 483-527: Jagannathan, M., Stephens, C and Weisbach, M 2000, 'Financial Flexibility and the Choice Between Dividends and Stock Repurchases,' *Journal of Financial Economics* 57, 355-384.

70 UBS presentation to Melbourne Centre of Financial Studies/AFR Symposium on Off-market Share Buybacks, October/November 2006.

repurchases totalled $10.5 billion, in the same period ordinary dividends totalled $220.3 billion and dominated repurchases in each year.[71]

5.45 All of this would suggest a lower value for franking credits.

Figure 5.3: Equally weighted average payout ratios of all listed ASX firms, 1996-2003



Source: James O'Day, *Are Firms Substituting Share Repurchases for Dividends: Australian Evidence*, 2004.

5.46 Moreover it can be shown that the benefit to shareholders not participating in a buyback increases with the size of the price discount involved in the buyback and that the tender system used for determining that discount has led to discounts smaller than might be expected in a competitive market.[72]

5.47 As noted in paragraphs 5.11 to 5.12 (and in further detail in Appendix I) this analysis does not take account of information effects arising from the announcement of the buyback.

5.48 Empirical evidence shows that the market reacts to the announcement of a buyback positively. Taken together with the possibility that the benefit of the discount to market price at which the shares are repurchased does not counter the cost of distributed franking credits, the evidence suggests that there must be other benefits to the buyback. It could be argued that whatever the benefit is, it outweighs any potential

---

71 Brown, C and O'Day, J 2005 '*The Dividend Substitution Hypothesis: Australian Evidence*', Working paper.

72 Brown, C and Davis, K 2007, '*Share buybacks and shareholder equity*' working paper.

detriment caused by the distribution of franking credits at a cost to non-participating shareholders.[73] In particular, there is some anecdotal evidence that certain non-participating shareholders (particularly non-residents) regard off-market share buybacks as an appropriate capital management strategy that adds to the value of companies. The fact that the market reaction is on average positive, could suggest that on average shareholders are collectively better off as a result of off-market share buybacks. However, some shareholders may gain more than others.

5.49 If non-participating shareholders are disadvantaged by off-market share buybacks, or do not benefit as much as participating shareholders, the possible approaches discussed in paragraphs 5.23 to 5.26 to aligning the taxation treatment of on- and off-market share buybacks would also reduce the potential inequities between different classes of shareholder.

5.50 Another way in which potential inequities could be addressed would be to allow the market to develop mechanisms to ensure that all shareholders derive the benefits of off-market share buybacks. There have been some examples of market responses that could enable all shareholders to gain from the tax benefits of off-market share buybacks. For example, in its off-market share buyback in 2005, St George Bank Limited issued rights to participate in the buyback to all shareholders. These rights could then be traded enabling non-participating shareholders to derive value from the buyback.

Q5.13 Do non-participating shareholders benefit from off-market share buybacks?

Q5.14 Under what conditions would this be the case?

Q5.15 To what extent do off-market share buybacks limit the ability of companies to frank future dividends?

Q5.16 Does the market attribute value to franking credits?

Q5.17 Are there possible market mechanisms that could address any inequities between shareholders? If so, what are their advantages and disadvantages? Are there any impediments to their development?

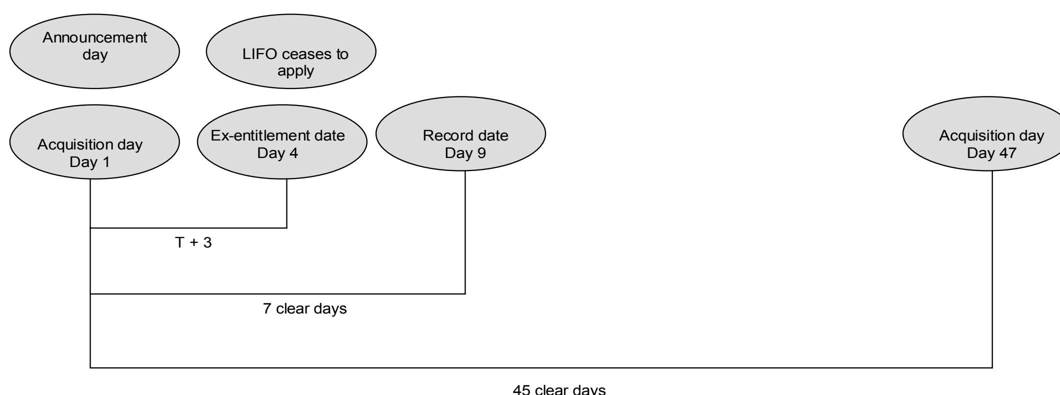
---

73 An alternative argument put by Cannavan, D, Finn, F and Gray, S 2004, '*The value of dividend imputation tax credits in Australia*' *Journal of Financial Economics,* 73, 1, 2004, 167-197 is that the value of franking credits is zero. This would imply that the positive response may arise purely mechanically, because the company is buying back shares at a price below their fundamental value.

Implications of the 45-day rule

5.51 Figure 5.4 outlines the minimum timing requirements for off-market share buybacks specified in the taxation law and ASX rules. Where there are 45 clear days between the date an investor enters into a contract to purchase shares and the date of acceptance of tenders, a shareholder who has purchased shares prior to the announcement of the buyback will be able to participate and get the benefit of franking credits. In many cases the timeframe for the buyback has allowed more than 45 clear days, allowing investors to purchase shares following the announcement and still qualify to participate in the buyback and receive franking credits.

Figure 5.4: Minimum timing requirements for an off-market share buyback



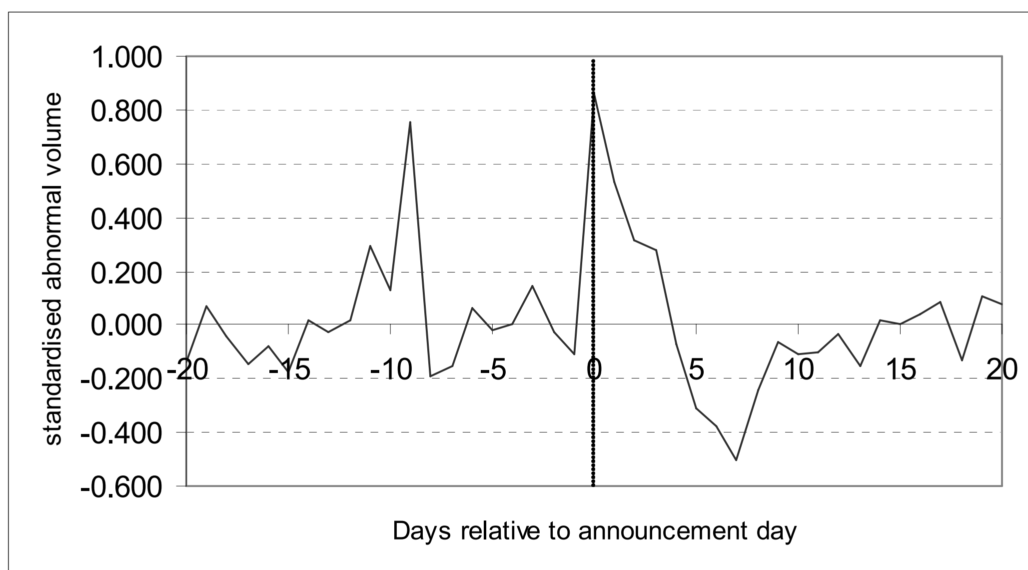
5.52 This allows shareholders who can benefit from the buyback to purchase shares and those who can not to sell shares. There is evidence to suggest that there is quite active trading in those days (and in some cases prior to the announcement where the company has previously indicated that it may conduct an off-market share buyback), which implies that some low-rate taxpayers and tax exempt charities may be purchasing shares specifically to participate in the buyback. Figure 5.5 shows that the significantly positive abnormal returns just after the announcement of a buyback and negative abnormal returns a few days later are associated with abnormal trading activity on those days.[74] Such abnormal trading volumes may lead to temporary price distortions in the market.

5.53 It is also evident from Figure 5.5 that there is abnormal trading activity prior to the announcement of the buyback. The abnormal volumes observed around 10 days

74 Figure 5.5 plots average standardised abnormal returns around the announcement date. On the announcement day standardised abnormal volume is over 85 per cent above normal levels and is significant using both parametric and non-parametric statistical tests. It remains positive on day one at over 53 per cent above normal levels. The standardised abnormal volume remains positive until four days after the announcement when there is a substantial reduction in trading volume. Using a non-parametric test, the standardised abnormal volume becomes significantly negative from day four and remains negative (and mostly significant) until day 13.

before the announcement appear to be the result of anticipatory trading prior to the announcement of the buyback in situations where the buyback intention has been foreshadowed or announced at the previous Annual General Meeting. This has happened in instances of earlier buybacks where there were fewer than 45 days between the announcement and close of the buyback. In these cases investors could purchase the shares and receive the tax benefits from selling those shares into the buyback only by purchasing shares prior to the announcement date. Anecdotal evidence suggests that anticipatory purchase of shares in companies likely to conduct a buyback is still occurring.

Figure 5.5: Standardised abnormal volumes



Source: Brown, C 'The Announcement Effects of Off-Market Share Repurchases in Australia', *Australian Journal of Management* Forthcoming.

5.54 Similar issues arise in relation to special dividends where investors can take advantage of timing issues to purchase shares so that they can receive the dividend.

5.55 This evidence supports the view that there may be some distortions to prices and market activity caused by tax-induced trading around the announcement of an off-market share buyback.

5.56 It is not a riskless strategy for those who purchase shares with the intention of participating in the buyback as there is no guarantee that all of the shares tendered will be bought back, and as noted in Chapter 3, there may be a scale-back. In addition, there is significant risk around reweighting a holding after participating in an off-market share buyback. Some funds cannot hold cash and so cannot reweight until they receive the buyback proceeds.

5.57 In addition to providing an opportunity for participants to buy shares to participate in a buyback, the timing of tender processes and the abnormal trading around that timing can also provide opportunities for speculative trading activity. It is

possible that investors could buy in prior to the peak and then sell at the peak of abnormal trading.

5.58 Some argue that the trading around a buyback announcement inappropriately benefits short-term shareholders at the expense of continuing shareholders in the company.

5.59 One approach that could be taken would be to prevent investors being able to benefit from franking credits in relation to shares purchased after the announcement of a buyback. This could be in addition to the 45-day rule and would need to accommodate the settlement period under the ASX trading rules. That is, an investor who entered into a contract to purchase shares four days prior to the announcement of the buyback would still be permitted to benefit from the franking credits.

5.60 It is likely to be difficult to deal with trading in anticipation of announcement of a buyback.

Q5.18 Should investors be able to buy shares following the announcement of a buyback and participate in the buyback?

Q5.19 If not, how could this be prevented? In particular, would there be issues associated with anticipatory trading?

Implications of the level of discount

5.61 In other jurisdictions buybacks are generally not conducted at a discount to the market price, but rather at a premium to the market price. The discount occurs in Australia because the current taxation arrangements allow shareholders to receive a franked dividend as part of the consideration for the buyback. The higher the discount, the greater the likelihood that a buyback will become attractive only to those who can use the tax benefits resulting from it (franking credit attached, the dividend and an effective utilisation of the capital loss), generally superannuation funds, charities and deductible gift recipients and individuals on nil or low marginal tax rates.

5.62 Initially tender-process buybacks encompassed a range of discounts and a slight premium at the top end. Recent examples do not have a premium and many of them are at the maximum discount acceptable to the Tax Office. The indicative price range specified at the announcement of the tender generally has an upper limit below the current market price of the shares. Table 5.1 illustrates the size of the discounts relative to market price which have occurred using the share price on the announcement date (this differs from the Tax Office approach where the discount is measured relative to the volume-weighted average share price in the five days up to and including the closing date of the buyback). Of the sample of companies shown in Table 5.1 a large portion executed the buyback at a substantial discount to market price.

Table 5.1: Buyback characteristics

ASX code	Date announced	Final buyback price	Franked dividend	Capital proceeds	Per cent discount/premium on announcement date price	Bought as per cent outstanding	Scaleback (per cent)	Dutch v Fixed
CBA	12/11/1997	$17.08	10.08	7.00	-0.1	4.0	29.7	Fixed
CBA	10/02/1999	$23.78	14.78	9.00	4.2	2.9	39.0	Fixed
SEV	11/03/1999	$5.00	0.00	5.00	-13.6	20.4	61.3	Dutch
WYL	17/05/1999	$4.61	2.68	1.93	-1.5	7.7	40.2	Fixed
CBA	30/09/1999	$27.00	0.00	27.00	-11.8	2.2	0.0	Dutch
WOW	14/02/2000	$4.92	2.47	2.45	3.9	8.7	45.7	Fixed
LLC	18/08/2000	$19.88	12.88	7.00	2.6	17.2	57.5	Fixed
ANN	02/10/2000	$1.60	0.00	1.60	-1.3	9.9	49.1	Dutch
CBA	13/02/2001	$27.84	17.84	10.00	7.2	2.0	94.7	Fixed
IAG	02/03/2001	$2.72	0.94	1.78	2.5	9.6	86.2	Fixed
BOQ	06/04/2001	$6.45	3.30	3.15	-3.0	5.9	70.8	Fixed
WOW	30/04/2001	$8.70	5.82	2.88	3.1	3.7	42.4	Fixed
TAB	21/03/2002	$2.74	0.39	2.35	2.5	9.8	0.0	Fixed
IAG	06/05/2002	$3.05	1.27	1.78	11.3	7.0	0.0	Fixed
SEV	27/08/2002	$5.80	3.77	2.03	-13.7	13.4	29.0	Dutch
WOW	24/02/2003	$11.40	8.52	2.88	-1.2	4.4	0.0	Dutch
TLS	03/10/2003	$4.20	2.70	1.50	15.8	1.9	65.6	Dutch
SEV	24/10/2003	$5.80	2.32	3.48	-0.2	13.4	0.0	Dutch
FGL	06/11/2003	$4.00	2.19	1.81	8.7	7.6	0.0	Dutch
MAY	30/01/2004	$3.55	0.00	**3.55**	-10.9	13.6	0.0	Dutch
CBA	11/02/2004	$27.50	16.50	**13.92**	13.2	1.5	0.0	Dutch

Table 5.1: Buyback characteristics (continued)

ASX code	Date announced	Final buyback price	Franked dividend	Capital proceeds	Per cent discount/premium on announcement date price	Bought as per cent outstanding	Scaleback (per cent)	Dutch v Fixed
IAG	30/04/2004	$4.40	2.62	**2.16**	9.5	5.6	0.0	Dutch
WBC	06/05/2004	$14.50	10.50	**7.21**	16.7	2.1	0.0	Dutch
TLS	27/09/2004	$4.05	2.55	**2.25**	13.8	3.0	11.3	Dutch
BHP	05/10/2004	$12.57	10.47	**4.04**	15.3	4.8	0.0	Dutch
ANN	12/10/2004	$9.20	0.00	**9.20**	-2.1	9.6	46.5	Dutch
BSL	23/02/2005	$7.75	4.68	**4.79**	17.2	3.5	0.0	Dutch
CXP	01/03/2005	$5.60	5.30	**0.44**	9.5	3.3	0.0	Dutch
RIO	11/03/2005	$36.70	32.70	**6.44**	18.9	2.0	0.0	Dutch
CML	17/03/2005	$8.30	5.30	**3.84**	14.1	5.7	0.0	Dutch
WBC	02/11/2005	$19.13	15.13	**5.18**	6.7	2.8	3.8	Dutch
SGB	16/12/2005	$25.69	19.15	**10.59**	11.9	2.2	70.8	Dutch
BHP	15/02/2006	$23.45	21.35	**5.96**	3.7	2.7	63.5	Dutch
CML	23/05/2006	$10.23	7.23	**4.19**	9.9	6.5	0.0	Dutch
BHP	7/02/2007	$24.81	22.31	**7.39**	12.2	2.4	62.4	Dutch
CXP	8/02/2007	$5.30	5.00	**0.70**	15.9	9.2	39.1	Dutch
FGL	20/02/2007	$5.90	4.09	**2.92**	13.1	3.3	42.0	Dutch
AWC	5/03/2007	$6.48	6.12	**1.36**	4.0	3.3	79.8	Dutch
JST	7/03/2007	$3.90	3.80	**0.15**	6.0	7.7	59.8	Dutch

Source: Brown, C and Davis, K 2007, 'Share buybacks and shareholder equity' Working paper

(a) The capital components in bold indicate those where a 'deemed' capital component has been calculated according to the rule defined in TD 2004/22. This will differ from the amount reported as the capital component in the offer documents from the companies.

(b) The discount/premium is in relation to the market price on the announcement date and may differ significantly from the discount/premium calculated in relation to the market value of the shares using the methodology set out in TD 2004/22.

5.63 The higher the level of discount, the greater the benefits of the buyback to the company and to the non-participating shareholders. Equally, however, as the level of discount increases the buyback will be attractive to even fewer classes of shareholders and the cost to the taxation revenue of the buyback will increase. The maximum acceptable level of discount has been set by the Tax Office at a 14 per cent cap on the basis that at discounts higher than that level the attractiveness of the buyback diminishes for all but zero rate (tax exempt charities) and 15 per cent taxpayers (superannuation funds), resulting in excessive streaming of franking credits to those taxpayers.

Debiting the franking account

5.64 Generally there will be some streaming of franking credits associated with tender-style buybacks and this has been acknowledged by the Commissioner.[75] As noted, one way in which the taxation revenue is compensated for the unequal distribution of franking credits arising from off-market share buybacks is through the application of the anti-avoidance and revenue integrity provisions in the tax law. The Commissioner is currently exercising his discretion under paragraph 177EA(5)(a) to debit the franking account of the company to compensate taxation revenue for avoided wastage of franking credits, in the cases where the streaming of franking credits from non-resident to resident shareholders has been identified. The debit is not designed to be punitive.

5.65 Class rulings do not disclose the quantum of the debit to a company's franking account due to secrecy provisions. However, in aggregate since 2003 around $1 billion has been debited to the franking accounts of listed companies that have engaged in off-market share buybacks. Unless disclosed by the company, shareholders and the market more generally will not be aware of the impact of an off-market share buyback on a company's franking account balance.

Q5.20 In what circumstances should section 177EA apply?

Q5.21 Should companies be required to disclose the impact of an off-market share buyback on their franking account balance?

5.66 Where the discount is no more than 14 per cent, the Commissioner has not been exercising his discretion under paragraph 177EA(5)(b) to deny the imputation benefit to participating shareholders. Beyond that point, the Commissioner would regard the level of streaming as excessive, rather than routine. There has been no case in which the Commissioner has exercised his discretion under this provision.

---

75 See Tax Office Practice Statement PS LA 2007/9, paragraph 141.

Q5.22 Should there be a cap on the level of discount in a tender-style off-market share buyback? If not, why not, and what might the implications be?

Q5.23 If a cap should be retained, is 14 per cent an appropriate maximum level of discount to deny franking credits to participating shareholders? If not, how should the acceptable level of discount be determined?

Resident-to-resident streaming

5.67 Paragraph 126 of Practice Statement Law Administration 2007/9 provides an example of how the Commissioner, in absence of unusual circumstances, would apply paragraph 177EA(5)(a) to debit a company's franking account. The Tax Office does not generally debit a company's franking account to include any avoided wastage of franking credits occasioned by streaming from high marginal tax-rate resident shareholders to lower tax-rate resident shareholders. There may be difficulties for the Tax Office in accessing information about company shareholding patterns, particularly prior to the finalisation of the buyback, to enable it to calculate the avoided wastage in these cases. Further, information would be required about the extent to which particular classes of shareholder participated in the buyback. Aside from timing issues, there would also be difficulties in identifying shareholdings held through nominees.

5.68 It would also be necessary to establish a methodology to calculate the avoided wastage. A possible methodology could be based on that set out in paragraph 3.74 which takes account of the proportion of resident shareholders not participating in the buyback.

Q5.24 Should franking accounts be debited for resident-to-resident streaming? If not, why?

Q5.25 If so, what would be an appropriate methodology for calculating resident-to-resident streaming?

Q5.26 How could the Tax Office identify company shareholding patterns?

Q5.27 Would it be appropriate to use some proxy measure to overcome timing difficulties?

Q5.28 How could nominee issues be dealt with?

Implications of the capital/dividend split

5.69 Another key factor influencing the attractiveness of an off-market share buyback to particular classes of shareholders is the extent to which the purchase price comprises a franked deemed dividend. It influences both the franking credits distributed to participating shareholders and the potential capital loss available. There is a strong relationship between the deemed dividend portion and the level of discount to the market price.[76]

5.70 As can be seen from Table 5.1, in many of the off-market share buybacks, and particularly the more recent ones, the deemed dividend has made up a significant proportion of the consideration.

Determining the split

5.71 While companies have some flexibility in determining the split between capital and dividend, as noted in Chapter 3, in applying the various anti-avoidance and integrity rules, the Tax Office has indicated that there are a number of methodologies for determining the split that it will regard as acceptable.

Q5.29 What is the appropriate methodology or methodologies for determining the capital/dividend split?

Q5.30 Should the methodology vary depending on the circumstances? If so, in what circumstances should a particular methodology be used?

Q5.31 Should the methodology be specified in the tax law? What should the consequences be of a split that differs from the methodology?

The capital loss

5.72 The capital/dividend split generally results in participating shareholders realising a capital loss on the sale of the shares back to the company, in circumstances where, in many cases, if the full sale price had been regarded as capital they would in fact have made a capital gain. This treatment ensures that participating shareholders are not subject to double taxation in relation to the sale, being taxed on both the deemed dividend and any capital gain.

5.73 However, because some shareholders are able to receive the dividend component effectively tax free or receive a refund of franking credits, those shareholders will be better off than if they sold the shares to a third party. There is more flexibility to

---

76 Brown, C and Efthim, K 2005, 'The Effect of Taxation on Equal Access Buybacks in Australia', *International Review of Finance*, 5 (3/4), 119-218.

achieve this outcome in relation to off-market share buybacks than there is in company liquidations or share cancellations.

Q5.32 Is it appropriate for shareholders who receive tax free dividends also to realise a capital loss by participating in an off-market share buyback?

Q5.33 If not, how should double taxation be prevented in this situation?

Q5.34 Should the same treatment be provided for both listed and unlisted companies?

SIMPLICITY

Reducing compliance costs

5.74 The process for completing an off-market share buyback is relatively resource-intensive for the Tax Office, ASIC and companies, with ruling and relief processes to facilitate the tender approach. The capital/dividend split and the level of discount in particular are not specified in the law. As noted in Chapter 2, this means that listed companies undertaking a buyback generally seek a class ruling and in most cases also seek a private binding ruling from the Tax Office.

5.75 The Tax Office then has to examine the transaction against the various anti-avoidance provisions. Those provisions do not provide tailored solutions to companies engaged in buybacks as they do not deal specifically or uniquely with off-market share buybacks. In particular, the anti-streaming rule in section 204-30 is difficult to apply in the context of off-market share buybacks as it requires analysis of events that occur after the buyback. Companies generally seek a ruling, in draft form, in advance of the announcement of the buyback. This generally means that the general anti-avoidance provision for franking credit trading in section 177EA is often a more appropriate and timely mechanism for the Commissioner to use.

5.76 Even where section 177EA is used in tender style buybacks where a discount is involved it is not possible to determine the final tax outcome of the buyback until after the buyback is completed. This is because the final price is not known until offers are accepted and for this reason a final ruling can not be published until after the buyback is completed.

5.77 While the release of the practice statement by the Tax Office will assist in providing certainty to market participants about Tax Office processes, each buyback still needs to be considered by the Tax Office on the particular facts and circumstances. Due to the marked increase in the number of off-market share buybacks, the Tax Office

is finding it administratively burdensome to exercise the discretion given under the anti-streaming rules.

5.78 For companies, again, while the practice statement provides a general guide on what to expect in the ruling process, they are still likely to go through those formal processes which can take up to eight weeks to complete. For unlisted companies, while a ruling is not necessary, the provisions may not be as straight forward to apply as they could be. In particular, no guidance is provided on the calculation of market value or the process for determining the capital/dividend split.

5.79 Further, for smaller shareholders, the complexity of the current taxation arrangements may make it difficult to make an assessment of whether it is beneficial for them to participate in the buyback. Explanatory information provided by companies does assist in this regard.

Q5.35 How could the compliance and administration costs of the provisions be reduced?

Q5.36 To what extent should current Tax Office practice, as outline in its practice statement, be specified in the tax law? Are there any issues or difficulties with doing so?

Q5.37 Should there be a specific provision for dealing with dividend and/or capital streaming in the context of off-market share buybacks, rather than relying on more generic anti-avoidance provisions?

Q5.38 Does the current approach to calculating market value cause any difficulties? What might the alternatives be?

Q5.39 How could the provisions be simplified to assist unlisted companies and smaller shareholders to understand their operation?

OTHER CONSIDERATIONS

5.80 As noted in Chapter 2, any changes made to the taxation arrangements for off-market share buybacks need to be considered in the context of the broader tax system and any potential linkages or interactions with other provisions. As the analysis in this paper has shown, mechanisms for returning cash to shareholders are very sensitive to the taxation arrangements applying to them, both absolutely and relatively. In considering issues with the current taxation arrangements and potential mechanisms for addressing them, regard also needs to be had to the impacts that this might have on alternative mechanisms, including ones that may develop in the future. In commenting on the issues raised in this Chapter, the Board is also interested in views on the impact of any possible changes to the arrangements for off-market share buybacks on other elements of the tax system and on the broader objectives of the tax system.

Appendix A: Consultation questions

Chapter 2: Background

Q2.1 The Board invites comment on the reasons companies, both listed and unlisted, use off-market share buybacks:

- How significant are each of the above explanations for the use of off-market share buybacks?
- Are there other reasons for the use of off-market share buybacks?

Q2.2 The Board invites comments on the alternatives to off-market share buybacks available to companies and the purposes for which they are used.

Q2.3 The Board invites comment on the reasons for the growth in use of off-market share buybacks:

- How significant are the explanations given above in driving the growth of off-market share buybacks?
- Are there other explanations for the growth in the use of off-market share buybacks?

Q2.4 Are these the appropriate policy objectives to consider?

Q2.5 Are there other policy objectives that should be considered?

Q2.6 Is the current balance between them appropriate?

Q2.7 Are there particular linkages and impacts with other parts of the tax system that the Board needs to be aware of?

Chapter 3: Current framework for share buybacks

Q3.1 The matters outlined in the practice statement are relevant to the Board's review and the Board would welcome comments on them as part of this discussion paper process.

Chapter 4: Implications of current treatment of off-market share buybacks

Q4.1 Do off-market share buybacks generally result in more than a short-term increase in earnings per share? If so, for how long?

Q4.2 If so, is this beneficial, and to whom? Or are other measures, such as share prices, more important for shareholders?

Q4.3 Do off-market share buybacks facilitate capital management strategies?

Q4.4 If so, are they more effective than other mechanisms for doing so, and why?

Q4.5 Are there other implications for public companies, particularly when compared with other capital management strategies?

Q4.6 Why are off-market share buybacks preferred over special dividends for the distribution of volatile profits?

Q4.7 Does the interaction between the provisions for taxation of off-market share buybacks and employee share schemes work appropriately?

Q4.8 If not, why, and what changes could be made to ensure a more appropriate interaction?

Q4.9 Are there other implications of the current treatment of off-market share buybacks for unlisted companies and their shareholders?

Q4.10 Are the current provisions easy for unlisted companies to understand and comply with? If not, what changes could be made to reduce compliance costs for unlisted companies?

Q4.11 Do unlisted companies have difficulties in calculating the market value? If so, what might be some approaches for dealing with these difficulties?

Q4.12 Should there be different taxation arrangements for off-market share buybacks for listed and unlisted companies?

Q4.13 Should the current arrangements be retained for unlisted companies, with any changes being made for listed companies only?

Q4.14 Are there circumstances in which listed companies should be treated in the same way as unlisted companies?

Q4.15 How should widely held unlisted companies be dealt with?

Q4.16 Would separate regimes increase compliance and administration costs?

CHAPTER 5: ASSESSMENT OF CURRENT TAXATION TREATMENT

Q5.1 Do off-market share buybacks lead to efficient economic outcomes?

Q5.2 If so, do they do so more efficiently than other mechanisms for returning surplus cash?

Q5.3 Why are they more efficient?

Q5.4 To what extent do the current taxation arrangements drive this outcome? Could the efficiencies be achieved without the current tax arrangements?

Q5.5 How do Australia's taxation arrangements for off-market share buybacks compare with those of our key trading partners? Are they more or less generous?

Q5.6 Would changes to our taxation arrangements reduce the competitiveness of our companies operating in international markets or make Australia a less attractive location for corporate operations? If so, how significant are the effects likely to be?

Q5.7 Are there other ways of addressing international competitiveness?

Q5.8 Is it appropriate that off-market share buybacks enable the optimal use of franking credits?

Q5.9 How does this impact on the underlying policy of the imputation system of equal distribution of franking credits over time? In particular, what are the likely impacts on taxation revenue?

Q5.10 What are the advantages and disadvantages of these approaches?

Q5.11 Are there other ways of reducing or eliminating the tax benefits associated with off-market share buybacks?

Q5.12 If there is not a separate regime for unlisted companies, what would the implication of these approaches be for those companies?

Q5.13 Do non-participating shareholders benefit from off-market share buybacks?

Q5.14 Under what conditions would this be the case?

Q5.15 To what extent do off-market share buybacks limit the ability of companies to frank future dividends?

Q5.16 Does the market attribute value to franking credits?

Q5.17 Are there possible market mechanisms that could address any inequities between shareholders? If so, what are their advantages and disadvantages? Are there any impediments to their development?

Q5.18 Should investors be able to buy shares following the announcement of a buyback and participate in the buyback?

Q5.19 If not, how could this be prevented? In particular, would there be issues associated with anticipatory trading?

Q5.20 In what circumstances should section 177EA apply?

Q5.21 Should companies be required to disclose the impact of an off-market share buyback on their franking account balance?

Q5.22 Should there be a cap on the level of discount in a tender-style off-market share buyback? If not, why not and what might the implications be?

Q5.23 If a cap should be retained, is 14 per cent an appropriate maximum level of discount to deny franking credits to participating shareholders? If not, how should the acceptable level of discount be determined?

Q5.24 Should franking accounts be debited for resident-to-resident streaming? If not, why?

Q5.25 If so, what would be an appropriate methodology for calculating resident-to-resident streaming?

Q5.26 How could the Tax Office identify company shareholding patterns?

Q5.27 Would it be appropriate to use some proxy measure to overcome timing difficulties?

Q5.28 How could nominee issues be dealt with?

Q5.29 What is the appropriate methodology or methodologies for determining the capital/dividend split?

Q5.30 Should the methodology vary depending on the circumstances? If so, in what circumstances should a particular methodology be used?

Q5.31 Should the methodology be specified in the tax law? What should the consequences be of a split that differs from the methodology?

Q5.32 Is it appropriate for shareholders who receive tax free dividends also to realise a capital loss by participating in an off-market share buyback?

Q5.33 If not, how should double taxation be prevented in this situation?

Q5.34 Should the same treatment be provided for both listed and unlisted companies?

Q5.35 How could the compliance and administration costs of the provisions be reduced?

Q5.36 To what extent should current Tax Office practice, as outlined in its practice statement, be specified in the tax law? Are there any issues or difficulties with doing so?

Q5.37 Should there be a specific provision for dealing with dividend and/or capital streaming in the context of off-market share buybacks, rather than relying on more generic anti-avoidance provisions?

Q5.38 Does the current approach to calculating market value cause any difficulties? What might the alternatives be?

Q5.39 How could the provisions be simplified to assist unlisted companies and smaller shareholders to understand their operation?

APPENDIX B: OFF-MARKET SHARE BUYBACKS BY LISTED COMPANIES SINCE 1997

Name	ASX code	Date announced	Final offer price	Capital component	Amount spent ($m)	Franking credits ($m)
CBA	CBA	12/11/1997	$17.08	$7.00	650.63	164.6
CBA	CBA	10/02/1999	$23.78	$9.00	650.77	173.3
Seven Network	SEV	11/03/1999	$5.00	$5.00	325.00	0.0
Aurion Gold (Goldfields Limited)	AOR	17/03/1999	$1.75	$1.75	132.53	0.0
Wattyl	WYL	17/05/1999	$4.61	$1.93	28.98	7.2
Carlton Investments Limited	CIN	30/09/1999	$12.50	$5.00	11.13	2.9
CBA	CBA	30/09/1999	$27.00	$27.00	553.14	0.0
Gowing Brothers	GOW	7/10/1999	$1.95	$0.75	1.36	0.4
Woolworths	WOW	14/02/2000	$4.92	$2.45	491.96	105.8
GUD Holdings	GUD	8/08/2000	$1.85	$1.85	1.17	0.0
Lend Lease Corporation Ltd	LLC	18/08/2000	$19.88	$7.00	1754.94	487.3
Ansell (Pacific Dunlop)	ANN/ PDP	2/10/2000	$1.60	$1.60	163.19	0.0
Port Douglas Reef Resorts Limited	PDR	23/10/2000	$0.18	$0.18	1.84	0.0
Capral Aluminium	CAA	13/02/2001	$2.19	$1.50	304.33	41.1
CBA	CBA	13/02/2001	$27.84	$10.00	699.96	192.2
IAG (NRMA)	IAG	2/03/2001	$2.72	$1.78	404.16	59.9
Bank of Qld	BOQ	6/04/2001	$6.45	$3.15	24.97	5.5
Woolworths	WOW	30/04/2001	$8.70	$2.88	348.21	99.8
Santos	STO	17/10/2001	$6.17	$2.63	250.00	61.5
TAB Limited	TAB	21/03/2002	$2.74	$2.35	134.01	8.2
Insurance Australia Group (Ltd)	IAG	6/05/2002	$3.05	$1.78	298.47	53.3
Seven Network 2	SEV	27/08/2002	$5.80	$2.03	193.87	54.0
Software Communication Group Limited	SOF	15/10/2002	$0.08	$0.08	3.41	0.0
Woolworths	WOW	24/02/2003	$11.40	$2.88	531.91	170.4
Telstra	TLS	3/10/2003	$4.20	$1.50	1000.57	275.7
Seven Network	SEV	24/10/2003	$5.80	$3.48	193.87	33.2

Name	ASX code	Date announced	Final offer price	Capital component	Amount spent ($m)	Franking credits ($m)
Foster's Group Limited	FGL	6/11/2003	$4.00	$1.81	668.43	156.8
Mayne Group	MAY	30/01/2004	$3.55	**$3.55**	359.69	0.0
CBA	CBA	11/02/2004	$27.50	**$13.92**	532.42	136.9
Lemarne Corp	LMC	24/02/2004	$2.52	**$1.51**		1.6
Insurance Australia Group (IAG)	IAG	30/04/2004	$4.40	**$2.16**	413.96	105.6
Westpac Banking Corp	WBC	6/05/2004	$14.50	**$7.21**	558.58	173.4
Telstra	TLS	27/09/2004	$4.05	**$2.25**	750.40	202.5
BHP Billiton Limited	BHP	5/10/2004	$12.57	**$4.04**	2271.61	810.9
Ansell	ANN	12/10/2004	$9.20	**$9.20**	155.00	0.0
Bluescope Steel Ltd	BSL	23/02/2005	$7.75	**$4.79**	200.39	51.9
Corporate Express Australia Ltd	CXP	01/03/2005	$5.60	**$0.44**	35.28	14.3
Rio Tinto Ltd	RIO	11/03/2005	$36.70	**$6.44**	1001.91	332.1
Coles Myer Ltd	CML	17/03/2005	$8.30	**$3.84**	584.60	160.0
Westpac Banking Corp	WBC	02/11/2005	$19.13	**$5.18**	1000.00	339.0
St George Bank	SGB	16/12/2005	$25.69	**$10.59**	300.00	95.8
BHP Billiton	BHP	15/02/2006	$23.45	**$5.96**	2250.05	878.0
Lemarne Corp	LMC	23/03/2006	$2.81	**$0.54**	14.59	5.1
Coles Myer Ltd	CML	23/05/2006	$10.23	**$4.19**	836.98	253.5
Newhaven Hotels Ltd	NHH	29/09/2006	$1.40	**$0.80**	11.84	2.2
Corporate Express Australia Ltd	CXP	8/02/2007	$5.30	**$0.70**	90.02	36.4
BHP Billiton	BHP	7/02/2007	$24.81	**$7.39**	3500.66	1349.1
Foster's Group Limited	FGL	20/02/2007	$5.90	**$2.92**	400.01	118.8
Alumina	AWC	5/03/2007	$6.48	**$1.36**	250.06	101.2
Just Group	JST	7/03/2007	3.90	**0.15**	65.13	27.1

The capital components in bold indicate those where the 'deemed' capital component has been calculated according to the rule defined in TD 2004/22. This will differ from the amount reported as the capital component in the offer documents from the companies.

Appendix C: Corporations Law extracts

Part 2J.1 — Share capital reductions and share buy backs

256A Purpose

This Part states the rules to be followed by a company for reductions in share capital and for share buy backs. The rules are designed to protect the interests of shareholders and creditors by:

(a) addressing the risk of these transactions leading to the company's insolvency;

(b) seeking to ensure fairness between the company's shareholders; and

(c) requiring the company to disclose all material information.

Division 2 — Share buy backs

Section 257A — the company's power to buy back its own shares

A company may buy back its own shares if:

(a) the buyback does not materially prejudice the company's ability to pay its creditors; and

(b) the company follows the procedures laid down in this Division.

Section 257B — Buyback procedure — general

(1) The following table specifies the steps required for, and the sections that apply to, the different types of buyback.

Procedures [and sections applied]	**Minimum holding**	**Employee share scheme**		**On-market**		**Equal access scheme**		**Selective buyback**
		within 10/12 limit	**over 10/12 limit**	**within 10/12 limit**	**over 10/12 limit**	**within 10/12 limit**	**over 10/12 limit**	
ordinary resolution **[257C]**	—	—	yes	—	yes	—	yes	—
special/unanimous resolution **[257D]**	—	—	—	—	—	—	—	yes
lodge offer documents with **ASIC [257E]**	—	—	—	—	—	yes	yes	yes
14 days notice **[257F]**	—	yes	yes	yes	yes	yes	yes	yes

Procedures [and sections applied]	Minimum holding	Employee share scheme		On-market		Equal access scheme		Selective buyback
		within 10/12 limit	over 10/12 limit	within 10/12 limit	over 10/12 limit	within 10/12 limit	over 10/12 limit	
disclose relevant information when offer made **[257G]**	—	—	—	—	—	yes	yes	yes
cancel shares **[257H]**	yes	yes	yes	yes	yes	yes	yes	yes
notify cancellation to ASIC **[254Y]**	yes	yes	yes	yes	yes	yes	yes	yes

Equal access scheme

(2) An equal access scheme is a scheme that satisfies all the following conditions:

(a) the offers under the scheme relate only to ordinary shares;

(b) the offers are to be made to every person who holds ordinary shares to buy back the same percentage of their ordinary shares;

(c) all of those persons have a reasonable opportunity to accept the offers made to them;

(d) buyback agreements are not entered into until a specified time for acceptances of offers has closed;

(e) the terms of all the offers are the same.

(3) In applying subsection (2), ignore:

(a) differences in consideration attributable to the fact that the offers relate to shares having different accrued dividend entitlements;

(b) differences in consideration attributable to the fact that the offers relate to shares on which different amounts remain unpaid;

(c) differences in the offers introduced solely to ensure that each shareholder is left with a whole number of shares.

10/12 limit

(4) The 10/12 limit for a company proposing to make a buyback is 10 per cent of the smallest number, at any time during the last 12 months, of votes attaching to voting shares of the company.

Exceeding the 10/12 limit

(5) A proposed buyback would exceed the 10/12 limit if the number of votes attaching to:

(a) all the voting shares in the company that have been bought back during the last 12 months; and

(b) the voting shares that will be bought back if the proposed buyback is made;

(c) would exceed the 10/12 limit.

On-market buybacks

(6) A buyback is an on-market buyback if it results from an offer made by a listed corporation on a prescribed financial market in the ordinary course of trading on that market.

(7) A buyback by a company (whether listed or not) is also an on-market buyback if it results from an offer made in the ordinary course of trading in a financial market outside Australia which ASIC declares in writing to be an approved overseas financial market for the purposes of this subsection. A buyback by a listed company is an on-market buyback under this subsection only if an offer to buyback those shares is also made on a prescribed financial market at the same time.

(8) A declaration under paragraph (7)(b) may be subject to conditions. Notice of the making of the declaration must be published in the *Gazette*.

Section 257C — Buyback procedure — shareholder approval if the 10/12 limit exceeded

Ordinary resolution required

(1) If section 257B applies this section to a buyback, the terms of the buyback agreement must be approved before it is entered into by a resolution passed at a general meeting of the company, or the agreement must be conditional on such an approval.

Information to accompany the notice of meeting

(2) The company must include with the notice of the meeting a statement setting out all information known to the company that is material to the decision how to vote on the resolution. However, the company does not have to disclose information if it would be unreasonable to require the company to do so because the company had previously disclosed the information to its shareholders.

Documents to be lodged with the ASIC

(3) Before the notice of the meeting is sent to shareholders, the company must lodge with ASIC a copy of:

(a) the notice of the meeting; and

(b) any document relating to the buyback that will accompany the notice of the meeting sent to shareholders.

Section 257D — Buyback procedure — special shareholder approval for selective buyback

Selective buyback requires special or unanimous resolution

(1) If section 257B applies this section to a buyback, the terms of the buyback agreement must be approved before it is entered into by either:

(a) a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person whose shares are proposed to be bought back or by their associates; or

(b) a resolution agreed to, at a general meeting, by all ordinary shareholders;

or the agreement must be conditional on such an approval.

Information to accompany the notice of meeting

(2) The company must include with the notice of the meeting a statement setting out all information known to the company that is material to the decision how to vote on the resolution. However, the company does not have to disclose information if it would be unreasonable to require the company to do so because the company had previously disclosed the information to its shareholders.

Documents to be lodged with the ASIC

(3) Before the notice of the meeting is sent to shareholders, the company must lodge with ASIC a copy of:

(a) the notice of the meeting; and

(b) any document relating to the buyback that will accompany the notice of the meeting sent to shareholders.

(4) ASIC may exempt a company from the operation of this section. The exemption:

(a) must be in writing; and

(b) must be granted before the buyback agreement is entered into; and

(c) may be granted subject to conditions.

Section 257E — Buyback procedure — lodgment of offer documents with ASIC

If section 257B applies this section to a buyback, the company must lodge with ASIC, before the buyback agreement is entered into, a copy of:

(a) a document setting out the terms of the offer; and

(b) any document that is to accompany the offer.

Section 257F — Notice of intended buyback

(1) If section 257B applies this section to a buyback, the company must satisfy the lodgment requirement in subsection (2) at least 14 days before:

(a) if the buyback agreement is conditional on the passing of a resolution under subsection 257C(1) or 257D(1) — the resolution is passed; or

(b) if it is not — the agreement is entered into.

(2) The company satisfies the lodgment requirement when it lodges with ASIC:

(a) documents under subsection 257C(3) or 257D(3) or section 257E; or

(b) a notice that the company intends to carry out the buyback.

Section 257G — Buyback procedure — disclosure of relevant information when offer made

If section 257B applies this section to a buyback, the company must include with the offer to buy back shares a statement setting out all information known to the company that is material to the decision whether to accept the offer.

Section 257H — Acceptance of offer and transfer of shares to the company

Effect of acceptance of the buyback offer on share rights

(1) Once a company has entered into an agreement to buy back shares, all rights attaching to the shares are suspended. The suspension is lifted if the agreement is terminated.

Shares transferred to the company and cancelled

(2) A company must not dispose of shares it buys back. An agreement entered into in contravention of this subsection is void.

(3) Immediately after the registration of the transfer to the company of the shares bought back, the shares are cancelled.

Section 257J — Signposts to other relevant provisions

The following table sets out other provisions of this Act that are relevant to buybacks.

Other provisions relevant to buybacks

	Provision	Comment
1	section 588G section 1317H	**liability of directors on insolvency** The directors may have to compensate the company if the company is, or becomes, insolvent when the company enters into the buyback agreement.
2	section 1324	**injunctions to restrain contravention** The Court may grant an injunction against conduct that constitutes, or would constitute, a contravention of this Act.
4	subsection 609(4) section 611 (item 19 of the table)	**application of takeover provisions** These sections deal with the application of Chapter 6 to buybacks.
5	section 259A	**consequences of failure to follow procedures—the company and the officers** If a company fails to follow the procedure in this Division, the company contravenes this section and the officers who are involved in the contravention are liable to a civil penalty under Part 9.4B and may commit an offence.
6	section 256D	**consequences of failure to follow procedures if reduction in share capital involved—the company and the officers** If the buyback involves a reduction in share capital and the company fails to follow the procedures in this Division, the company contravenes this section and the officers who are involved in the contravention are liable to a civil penalty under Part 9.4B and may commit an offence.
7	section 256D	**consequences of failure to follow procedures if reduction in share capital involved—the transaction** This section provides that a failure to follow the procedures for share capital reductions does not affect the validity of the buyback transaction itself.
8	Chapter 6CA	**continuous disclosure provisions** Under this chapter a disclosing entity is required to disclose information about its securities that is material and not generally available.
9	Chapter 2E	**benefits to related parties to be disclosed** Under this chapter, a financial benefit to a director or other related party may need to be approved at a general meeting before it is given.
10	section 125	**provisions in constitution** This section deals with the way in which a company's constitution may restrict the exercise of the company's powers and the consequences of a failure to observe these restrictions.
11	sections 246B-246G	**variation of class rights** These sections deal with the variation of rights attached to a class of shares. This variation may be governed by the provisions of a company's constitution.

Subsection 254W(1)

Each share in a class of shares in a public company has the same dividend rights unless:

(a) the company has a constitution and it provides for the shares to have different dividend rights; or

(b) different dividend rights are provided for by special resolution of the company.

Subsection 181(1)

A director or other officer of a corporation must exercise their powers and discharge their duties:

(a) In good faith in the best interest of the corporation: and

(b) For a proper purpose.

APPENDIX D: TAXATION LAW EXTRACTS

OFF-MARKET SHARE BUYBACKS

Section 159GZZZP — Part of off-market purchase price is a dividend

(1) For the purposes of this Act, but subject to subsection (1A), where a buyback of a share or non-share equity interest by a company is an off-market purchase, the difference between:

(a) the purchase price; and

(b) the part (if any) of the purchase price in respect of the buyback of the share or non-share equity interest which is debited against amounts standing to the credit of:

(i) the company's share capital account if it is a share that is bought back; or

(ii) the company's share capital account or non-share capital account if it is a non-share equity interest that is bought back;

is taken to be a dividend paid by the company:

(c) to the seller as a shareholder in the company; and

(d) out of profits derived by the company; and

(e) on the day the buyback occurs.

(1A) If the dividend is included to any extent in the seller's assessable income of any year of income, it is not taken into account to that extent under section 118-20 of the *Income Tax Assessment Act 1997*.

(2) The remainder of the purchase price is taken not to be a dividend for the purposes of this Act.

Section 159GZZZQ — Consideration in respect of off-market purchase

(1) Subject to this section, if a buyback of a share is an off-market purchase, then:

(a) in determining, for the purposes of this Act:

(i) whether an amount is included in the assessable income of the seller under a provision of this Act other than Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (about CGT); or

(ii) whether an amount is allowable as a deduction to the seller; or

(b) whether the seller makes a capital gain or capital loss;

in respect of the buyback, the seller is taken to have received or to be entitled to receive, as consideration in respect of the sale of the share, an amount equal to the purchase price in respect of the buyback.

Deemed consideration increased to market value

(2) If apart from this section:

(a) the purchase price in respect of the buyback;

is less than:

(b) 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;

then, subject to subsection (3), in making the determinations mentioned in paragraphs (1)(a) and (b), the amount of consideration that the seller is taken to have received or to be entitled to receive in respect of the sale of the share is equal to the market value mentioned in paragraph (b) of this subsection.

Deemed consideration reduced where dividend assessable etc.

(3) Subject to subsection (8), if there is a reduction amount in respect of the buyback (see subsection (4)), then, in making the determinations mentioned in paragraphs (1)(a) and (b), the amount of consideration that the seller is taken to have received or to be entitled to receive in respect of the sale of the share, after any application of subsection (2), is reduced by the reduction amount.

Reduction amount

(4) The following steps are to be taken in working out whether there is a reduction amount in respect of the buyback:

(a) first, work out whether the whole or part of the purchase price in respect of the buyback is taken to be a dividend by section 159GZZZP;

(b) second, for any amount satisfying paragraph (a), work out whether the whole or part of it is either:

(i) included in the seller's assessable income of any year of income (disregarding section 128D of this Act and section 802-15 of the *Income Tax Assessment Act 1997*); or

(ii) (an eligible non-capital amount (see subsection (5)).

The amount worked out is the ***reduction amount*** in respect of the buyback.

Eligible non-capital amount

(5) An amount is an ***eligible non-capital amount*** if it is neither:

(a) debited against a share capital account or a reserve to the extent that it consists of profits from the revaluation of assets of the company that have not been disposed of by the company; nor

(b) attributable, either directly or indirectly, to amounts that were transferred from such an account or reserve of the company.

Debit for deemed dividend

(7) For the purposes of subsection (5), an amount of the purchase price that is taken to be a dividend by section 159GZZZP is taken to have been debited against the account or reserves against which the purchase price was debited, and to the same extent.

Offsetable amount excluded from reduction where loss

(8) If:

(a) the seller is a corporate tax entity; and

(b) the amount of consideration that the seller is taken by subsection (1) or (2) to have received or to be entitled to receive in respect of the sale of the share is, apart from this subsection, reduced by a reduction amount under subsection (3); and

(c) the dividend mentioned in paragraph (4)(a), so far as it does not exceed the reduction amount, consists to any extent of an offsetable amount (see subsection (9)); and

(d) disregarding this subsection, as a result of the operation of this section:

(i) for the purposes of Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (about CGT), the seller incurs a capital loss or an increased capital loss (which loss or increase is the ***loss amount***) in respect of the buyback; or

(ii) a loss, or an increased loss, (which loss or increase is also the ***loss amount***) in respect of the buyback is allowable as a deduction to the seller under a provision of a Part of this Act other than Part 3-1 or 3-3 of the *Income Tax Assessment Act 1997*; or

(iii) the amount of a deduction allowable from the seller's assessable income of any year of income in respect of the issue or acquisition of the share exceeds, or exceeds by a greater amount, (the excess or increased excess is also the ***loss amount***) the amount included in the seller's assessable income of any year of income in respect of the buyback of the share;

then the reduction in the amount of the consideration under subsection (3) is instead a reduction equal to:

(e) the reduction amount;

less:

(f) so much of the offsetable amount as does not exceed the loss amount.

Meaning of offsetable amount

(9) For the purposes of subsection (8), if the seller is entitled to a tax offset under Division 207 of the *Income Tax Assessment Act 1997* in the seller's assessment for a year of income in respect of the dividend, the dividend consists of an ***offsetable amount*** worked out using the formula:

$$\frac{\text{Amount of offset}}{\text{Corporate tax rate}}$$

ON-MARKET PURCHASES

Section 159GZZZR — No part of on-market purchase price is a dividend

For the purposes of this Act, where a buyback by a company of a share is an on-market purchase, no part of the purchase price in respect of the buyback of the share is taken to be a dividend.

Section 159GZZZS — Consideration in respect of on-market purchase

Where a buyback is an on-market purchase, then:

(a) in determining, for the purposes of this Act:

(i) whether an amount is included in the assessable income of the seller under a provision of this Act other than Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (about CGT); or

(ii) whether an amount is allowable as a deduction to the seller; or

(b) whether the seller makes a capital gain or capital loss;

in respect of the buyback, the seller is taken to have received or to be entitled to receive, as consideration in respect of the sale of the share, the purchase price in respect of the buyback of the share.

ANTI-AVOIDANCE RULES

Income Tax Assessment Act 1936

Section 45A Streaming of dividends and capital benefits

Application of section

(1) This section applies in respect of a company that, whether in the same year of income or in different years of income, streams the provision of capital benefits and the payment of dividends to its shareholders in such a way that:

(a) the capital benefits are, or apart from this section would be, received by shareholders (the advantaged shareholders) who would, in the year of income in which the capital benefits are provided, derive a greater benefit from the capital benefits than other shareholders; and

(b) it is reasonable to assume that the other shareholders (the disadvantaged shareholders) have received, or will receive, dividends.

However, it does not apply if section 45 applies in relation to the streaming or in the circumstances set out in subsection (5).

Commissioner to determine that section 45C applies

(2) The Commissioner may make, in writing, a determination that section 45C applies in relation to the whole, or a part, of the capital benefits. A determination does not form part of an assessment.

Note: Subsection (6) limits the determination to a part of the capital benefit in certain cases.

Meaning of provision of capital benefit

(3) A reference to the provision of a capital benefit to a shareholder in a company is a reference to any of the following:

(a) the provision to the shareholder of shares in the company;

(b) the distribution to the shareholder of share capital or share premium;

(c) something that is done in relation to a share that has the effect of increasing the value of a share (which may or may not be the same share) held by the shareholder.

(3A) For the purposes of this section, a non share distribution to an equity holder is taken to be the distribution to the equity holder of share capital to the extent to which it is a non share capital return.

Meaning of greater benefit from capital benefits

(4) The circumstances in which a shareholder would, in a year of income, derive a greater benefit from capital benefits than another shareholder include, but are not limited to, any of the following circumstances existing in relation to the first shareholder and not in relation to the other shareholder:

(a) some or all of the shares in the company held by the shareholder were acquired, or are taken to have been acquired, before 20 September 1985;

(b) the shareholder is a non resident;

(c) the cost base (for the purposes of Part IIIA) of the relevant share is not substantially less than the value of the applicable capital benefit;

(d) the shareholder has a net capital loss for the year of income in which this capital benefit is provided;

(e) the shareholder is a private company who would not have been entitled to a rebate under former section 46F if the shareholder had received the dividend that was paid to the disadvantaged shareholder;

(f) the shareholder has income tax losses.

Certain capital benefits not covered

(5) This section does not apply where the capital benefit provided to the advantaged shareholders is the provision of shares and it is reasonable to assume that the disadvantaged shareholders have received, or will receive, fully franked dividends.

Determination limited in certain cases

(6) If the capital benefit provided to the advantaged shareholders is the provision of shares and it is reasonable to assume that the disadvantaged shareholders have received, or will receive, partly franked dividends, the Commissioner may only make a determination under subsection (2) in relation to so much of the capital benefit as the Commissioner considers relates to the unfranked part of the dividend.

Section 45B Schemes to provide certain benefits

Purpose of section

(1) The purpose of this section is to ensure that relevant amounts are treated as dividends for taxation purposes if:

(a) components of a demerger allocation as between capital and profit do not reflect the circumstances of a demerger; or

(b) certain payments, allocations and distributions are made in substitution for dividends.

Application of section

(2) This section applies if:

(a) there is a scheme under which a person is provided with a demerger benefit or a capital benefit by a company; and

(b) under the scheme, a taxpayer (the relevant taxpayer), who may or may not be the person provided with the demerger benefit or the capital benefit, obtains a tax benefit; and

(c) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling a taxpayer (the relevant taxpayer) to obtain a tax benefit.

Commissioner to determine that section 45BA or 45C applies

(3) The Commissioner may make, in writing, a determination that:

(a) section 45BA applies in relation to the whole, or a part, of the demerger benefit; or

(b) section 45C applies in relation to the whole, or a part, of the capital benefit.

A determination does not form part of an assessment.

Note: If section 45BA applies in relation to the whole, or a part, of a demerger benefit, this benefit may be a capital benefit.

Meaning of provided with a demerger benefit

(4) A person is provided with a demerger benefit if in relation to a demerger:

(a) a company provides the person with ownership interests in that or another company; or

(b) something is done in relation to an ownership interest owned by the person that has the effect of increasing the value of an ownership interest (which may or may not be the same ownership interest) owned by the person.

Meaning of provided with a capital benefit

(5) A reference to a person being provided with a capital benefit is a reference to any of the following:

(a) the provision of ownership interests in a company to the person;

(b) the distribution to the person of share capital or share premium;

(c) something that is done in relation to an ownership interest that has the effect of increasing the value of an ownership interest (which may or may not be the same interest) that is held by the person.

(6) However, a person is not provided with a capital benefit to the extent that the provision of interests, the distribution or the thing done referred to in subsection (5) involves the person receiving a demerger dividend.

(7) For the purposes of this section, a non share distribution to an equity holder is taken to be the distribution to the equity holder of share capital to the extent to which it is a non share capital return.

Meaning of relevant circumstances of scheme

(8) The relevant circumstances of a scheme include:

(a) the extent to which the demerger benefit or capital benefit is attributable to capital or the extent to which the demerger benefit or capital benefit is attributable to profits (realised and unrealised) of the company or of an associate (within the meaning in section 318) of the company;

(b) the pattern of distributions of dividends, bonus shares and returns of capital or share premium by the company or by an associate (within the meaning in section 318) of the company;

(c) whether the relevant taxpayer has capital losses that, apart from the scheme, would be carried forward to a later year of income;

(d) whether some or all of the ownership interests in the company or in an associate (within the meaning in section 318) of the company held by the

relevant taxpayer were acquired, or are taken to have been acquired, by the relevant taxpayer before 20 September 1985;

(e) whether the relevant taxpayer is a non resident;

(f) whether the cost base (for the purposes of the Income Tax Assessment Act 1997) of the relevant ownership interest is not substantially less than the value of the applicable demerger benefit or capital benefit;

(g) if the scheme involves the distribution of share capital or share premium—whether the interest held by the relevant taxpayer after the distribution is the same as the interest would have been if an equivalent dividend had been paid instead of the distribution of share capital or share premium;

(h) if the scheme involves the provision of ownership interests and the later disposal of those interests, or an increase in the value of ownership interests and the later disposal of those interests:

(i) the period for which the ownership interests are held by the holder of the interests; and

(ii) when the arrangement for the disposal of the ownership interests was entered into;

(i) for a demerger only:

(i) whether the profits of the demerging entity and demerged entity are attributable to transactions between the entity and an associate (within the meaning in section 318) of the entity; and

(ii) whether the assets of the demerging entity and demerged entity were acquired under transactions between the entity and an associate (within the meaning in section 318) of the entity;

(j) any of the matters referred to in subparagraphs 177D(b)(i) to (viii).

Meaning of obtaining a tax benefit

(9) A relevant taxpayer obtains a tax benefit if an amount of tax payable, or any other amount payable under this Act, by the relevant taxpayer would, apart from this section, be less than the amount that would have been payable, or would be payable at a later time than it would have been payable, if the demerger benefit had been an assessable dividend or the capital benefit had been a dividend.

Expressions to have same meanings as in Part IIIAA

(10) Expressions used in this section that are defined in Part IIIAA have the same meanings as in that Part.

Section 177EA Creation of franking debit or cancellation of franking credits

(1) In this section, unless the contrary intention appears:

- *relevant circumstances* has a meaning affected by subsection (17);
- *relevant taxpayer* has the meaning given by subsection (3);
- *scheme for a disposition*, in relation to membership interests or an interest in membership interests, has a meaning affected by subsection (14).

(2) An expression used in this section that is defined in the Income Tax Assessment Act 1997 has the same meaning as in that Act, except to the extent that its meaning is extended by subsection (16), (18) or (19), or affected by subsection (15).

Application of section

(3) This section applies if:

(a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and

(b) either:

(i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or

(ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and

(c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and

(d) except for this section, the person (the relevant taxpayer) would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and

(e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose

(whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

Bare acquisition of membership interests or interest in membership interests

(4) It is not to be concluded for the purposes of paragraph (3)(e) that a person entered into or carried out a scheme for a purpose mentioned in that paragraph merely because the person acquired membership interests, or an interest in membership interests, in the entity.

Commissioner to determine franking debit or deny franking credit

(5) The Commissioner may make, in writing, either of the following determinations:

(a) if the corporate tax entity is a party to the scheme, a determination that a franking debit or exempting debit of the entity arises in respect of each distribution made to the relevant taxpayer or that flows indirectly to the relevant taxpayer;

(b) a determination that no imputation benefit is to arise in respect of a distribution or a specified part of a distribution that is made, or that flows indirectly, to the relevant taxpayer.

A determination does not form part of an assessment.

Notice of determination

(6) If the Commissioner makes a determination under subsection (5), the Commissioner must:

(a) in respect of a determination made under paragraph (5)(a)—serve notice in writing of the determination on the corporate tax entity; or

(b) in respect of a determination made under paragraph (5)(b)—serve notice in writing of the determination on the relevant taxpayer.

The notice may be included in a notice of assessment.

Publication in national newspaper of determination in relation to listed public company denying imputation benefit

(7) If the Commissioner makes a determination under paragraph (5)(b), in respect of a distribution made by a listed public company, the Commissioner is taken to have served notice in writing of the determination on the relevant taxpayer if the Commissioner causes the notice to be published in a daily newspaper that circulates generally in each State, the Australian Capital Territory and the Northern Territory. The notice is taken to have been served on the day on which the publication takes place.

Evidence of determination

(8) The production of:

(a) a notice of a determination; or

(b) a document signed by the Commissioner, a Second Commissioner or a Deputy Commissioner purporting to be a copy of a determination;

is conclusive evidence:

(c) of the due making of the determination; and

(d) except in proceedings under Part IVC of the Taxation Administration Act 1953 on an appeal or review relating to the determination, that the determination is correct.

Objections

(9) If a taxpayer to whom a determination relates is dissatisfied with the determination, the taxpayer may object against it in the manner set out in Part IVC of the Taxation Administration Act 1953.

Effect of determination of franking debit or exempting debit

(10) If the Commissioner makes a determination under paragraph (5)(a):

(a) on the day on which notice in writing of the determination is served on the entity, a franking debit or exempting debit of the corporate tax entity arises in respect of the distribution; and

(b) the amount of the franking debit or exempting debit is such amount as is stated in the Commissioner's determination, being an amount that:

(i) the Commissioner considers reasonable in the circumstances; and

(ii) does not exceed the amount of the franking debit or exempting debit of the entity arising under item 1 of the table in section 205 30 of the Income Tax Assessment 1997 or item 2 of the table in section 208 120 of that Act in respect of the distribution.

Effect of determination that no imputation benefit is to arise

(11) If the Commissioner makes a determination under paragraph (5)(b), the determination has effect according to its terms.

Application of section to non share dividends

(12) This section:

(a) applies to a non share equity interest in the same way as it applies to a membership interest; and

(b) applies to an equity holder in the same way as it applies to a member; and

(c) applies to a non share dividend in the same way as it applies to a distribution.

Meaning of interest in membership interests

(13) A person has an interest in membership interests if:

(a) the person has any legal or equitable interest in the membership interests; or

(b) the person is a partner in a partnership and:

(i) the assets of the partnership include, or will include, the membership interests; or

(ii) the partnership derives, or will derive, income indirectly through interposed companies, trusts or partnerships, from distributions made on the membership interests; or

(c) the person is a beneficiary of a trust (including a potential beneficiary of a discretionary trust) and:

(i) the membership interests form, or will form, part of the trust estate; or

(ii) the trust derives, or will derive, income indirectly through interposed companies, trusts or partnerships, from distributions made on the membership interests.

Meaning of scheme for a disposition

(14) A scheme for a disposition of membership interests or an interest in membership interests includes, but is not limited to, a scheme that involves any of the following:

(a) issuing the membership interests or creating the interest in membership interests;

(b) entering into any contract, arrangement, transaction or dealing that changes or otherwise affects the legal or equitable ownership of the membership interests or interest in membership interests;

(c) creating, varying or revoking a trust in relation to the membership interests or interest in membership interests;

(d) creating, altering or extinguishing a right, power or liability attaching to, or otherwise relating to, the membership interests or interest in membership interests;

(e) substantially altering any of the risks of loss, or opportunities for profit or gain, involved in holding or owning the membership interests or having the interest in membership interests;

(f) the membership interests or interest in membership interests beginning to be included, or ceasing to be included, in any of the insurance funds of a life assurance company.

(15) In determining whether a distribution flows indirectly to a person, assume that the following provisions of the Income Tax Assessment Act 1997 had not been enacted:

(a) section 295 385 (about income from assets set aside to meet current pension liabilities), section 295 390 (about income from other assets used to meet current pension liabilities) and 295 400 (about income of a PST attributable to current pension liabilities); or

(b) paragraph 320 37(1)(a) (about segregated exempt assets) or paragraph 320 37(1)(d) (about income bonds, funeral policies and scholarship plans).

When imputation benefit is received

(16) A taxpayer to whom a distribution flows indirectly receives an imputation benefit as a result of the distribution if:

(a) the taxpayer is entitled to a tax offset under Division 207 of the Income Tax Assessment Act 1997 as a result of the distribution; or

(b) where the taxpayer is a corporate tax entity—a franking credit would arise in the franking account of the taxpayer as a result of the distribution.

Note: Where the distribution is made directly to the taxpayer, see subsection 204 30(6) of the Income Tax Assessment Act 1997 for a definition of imputation benefit.

Meaning of relevant circumstances of scheme

(17) The relevant circumstances of a scheme include the following:

(a) the extent and duration of the risks of loss, and the opportunities for profit or gain, from holding membership interests, or having interests in membership interests, in the corporate tax entity that are respectively borne by or accrue to the parties to the scheme, and whether there has been any change in those risks and opportunities for the relevant taxpayer or any other party to the scheme (for example, a change resulting from the making

of any contract, the granting of any option or the entering into of any arrangement with respect to any membership interests, or interests in membership interests, in the corporate tax entity);

(b) whether the relevant taxpayer would, in the year of income in which the distribution is made, or if the distribution flows indirectly to the relevant taxpayer, in the year in which the distribution flows indirectly to the relevant taxpayer, derive a greater benefit from franking credits than other entities who hold membership interests, or have interests in membership interests, in the corporate tax entity;

(c) whether, apart from the scheme, the corporate tax entity would have retained the franking credits or exempting credits or would have used the franking credits or exempting credits to pay a franked distribution to another entity referred to in paragraph (b);

(d) whether, apart from the scheme, a franked distribution would have flowed indirectly to another entity referred to in paragraph (b);

(e) if the scheme involves the issue of a non share equity interest to which section 215 10 of the Income Tax Assessment Act 1997 applies—whether the corporate tax entity has issued, or is likely to issue, equity interests in the corporate tax entity:

 (i) that are similar, from a commercial point of view, to the non share equity interest; and

 (ii) distributions in respect of which are frankable;

(f) whether any consideration paid or given by or on behalf of, or received by or on behalf of, the relevant taxpayer in connection with the scheme (for example, the amount of any interest on a loan) was calculated by reference to the imputation benefits to be received by the relevant taxpayer;

(g) whether a deduction is allowable or a capital loss is incurred in connection with a distribution that is made or that flows indirectly under the scheme;

(ga) whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is sourced, directly or indirectly, from unrealised or untaxed profits;

(h) whether a distribution that is made or that flows indirectly under the scheme to the relevant taxpayer is equivalent to the receipt by the relevant taxpayer of interest or of an amount in the nature of, or similar to, interest;

(i) the period for which the relevant taxpayer held membership interests, or had an interest in membership interests, in the corporate tax entity;

(j) any of the matters referred to in subparagraphs 177D(b)(i) to (viii).

Meaning of greater benefit from franking credits

(18) The following subsection lists some of the cases in which a taxpayer to whom a distribution flows indirectly receives a greater benefit from franking credits than an entity referred to in paragraph (17)(b). It is not an exhaustive list.

(19) A taxpayer to whom a distribution flows indirectly receives a greater benefit from franking credits than an entity referred to in paragraph (17)(b) if any of the following circumstances exist in relation to that entity in the year of income in which the distribution giving rise to the benefit is made, and not in relation to the taxpayer if:

(a) the entity is not an Australian resident; or

(b) the entity would not be entitled to any tax offset under Division 207 of the Income Tax Assessment Act 1997 because of the distribution; or

(c) the amount of income tax that would be payable by the entity because of the distribution is less than the tax offset to which the entity would be entitled; or

(d) the entity is a corporate tax entity at the time the distribution is made, but no franking credit arises for the entity as a result of the distribution; or

(e) the entity is a corporate tax entity at the time the distribution is made, but cannot use franking credits received on the distribution to frank distributions to its own members because:

(i) it is not a franking entity; or

(ii) it is unable to make frankable distributions.

Note: Where the distribution is made directly to the taxpayer, see subsections 204 30(7), (8), (9) and (10) of the Income Tax Assessment Act 1997 for a list of circumstances in which the taxpayer will be treated as deriving a greater benefit from franking credits than another entity.

Income Tax Assessment Act 1997

Section 204-30 Streaming distributions

Commissioner's power to make a determination when distributions or distributions and other benefits are streamed

(1) This section empowers the Commissioner to make determinations if an entity streams one or more *distributions (or one or more distributions and the giving of other benefits), whether in a single *franking period or in a number of franking periods, in such a way that:

(a) an *imputation benefit is, or apart from this section would be, received by a *member of the entity as a result of the distribution or distributions; and

(b) the member would *derive a *greater benefit from franking credits than another member of the entity; and

(c) the other member of the entity will receive lesser imputation benefits, or will not receive any imputation benefits, whether or not the other member receives other benefits.

(d) The member that derives the greater benefit from franking credits is the ***favoured member***. The member that receives the lesser imputation benefits is the ***disadvantaged member***.

Examples of other benefits

(2) These are examples of the giving of other benefits:

(a) issuing bonus *shares;

(b) returning *paid-up share capital;

(c) forgiving a debt;

(d) the entity or another entity making a payment of any kind, or giving any property, to a *member or to another person on a member's behalf.

Nature of the determination that the Commissioner may make

(3) The Commissioner may make one or more of these determinations:

(a) that a specified *franking debit arises in the *franking account of the entity, for a specified *distribution or other benefit to a disadvantaged member;

(b) that a specified *exempting debit arises in the *exempting account of the entity, for a specified *distribution or other benefit to a disadvantaged member;

(c) that no *imputation benefit is to arise in respect of a distribution that is made to a favoured member and specified in the determination.

A determination must be in writing.

(4) The Commissioner may:

(a) specify the *franking debit under paragraph (3)(a) by specifying the *franking percentage to be used in working out the amount of the debit; and

(b) specify the *exempting debit under paragraph (3)(b) by specifying the *exempting percentage to be used in working out the amount of the debit.

(5) The Commissioner may specify the *distribution under paragraph (3)(a), (b) or (c) by specifying:

(a) the date on which the distribution was made, or the period during which the distribution was made; and

(b) the member, or class of members, to whom the distribution was made.

What is an imputation benefit?

(6) A *member of an entity receives an ***imputation benefit*** as a result of a distribution if:

(a) the member is entitled to a *tax offset under Division 207 as a result of the distribution; or

(b) an amount would be included in the member's assessable income as a result of the distribution because of the operation of section 207-35; or

(c) a *franking credit would arise in the *franking account of the member as a result of the distribution; or

(d) an *exempting credit would arise in the *exempting account of the member as a result of the distribution; or

(e) the member would not be liable to pay *withholding tax on the distribution, because of the operation of paragraph 128B(3)(ga) of the *Income Tax Assessment Act 1936*; or

(f) the member is entitled to a *tax offset under section 210-170 as a result of the distribution.

When does a favoured member derive greater benefit from franking credits?

(7) The following subsection lists some of the cases in which a *member of an entity *derives a ***greater benefit from franking credits*** than another member of the entity. It is not an exhaustive list.

(8) A *member of an entity *derives a ***greater benefit from franking credits*** than another member of the entity if any of the following circumstances exist in relation to the other member in the income year in which the distribution giving rise to the benefit is made, and not in relation to the first member:

(a) the other member is a foreign resident;

(b) (the other member would not be entitled to any *tax offset under Division 207 because of the distribution;

(c) the amount of income tax that, apart from this Division, would be payable by the other member because of the distribution is less than the tax offset to which the other member would be entitled;

(d) the other member is a *corporate tax entity at the time the distribution is made, but no *franking credit arises for the entity as a result of the distribution;

(e) the other member is a *corporate tax entity at the time the distribution is made, but cannot use *franking credits received on the distribution to *frank distributions to its own members because:

(i) it is not a *franking entity; or

(ii) it is unable to make *frankable distributions;

(f) the other member is an *exempting entity.

(9) A *member of an entity *derives a ***greater benefit from franking credits*** than another member of the entity if any of the following circumstances exist in relation to the first member in the income year in which the *distribution giving rise to the benefit is made, and not in relation to the other member:

(a) a *franking credit arises for the first member under item 5, 6 or 7 of the table in section 208-130 (distributions by *exempting entities to exempting entities);

(b) a franking credit or *exempting credit arises for the first member because the distribution is *franked with an exempting credit;

(c) the first member is entitled to a *tax offset because:

(i) the distribution is a *franked distribution made by an exempting entity; or

(ii) the distribution is *franked with an exempting credit.

(10) A *member of an entity *derives a ***greater benefit from franking credits*** than another member if the first member is entitled to a *tax offset under section 210-170 as a result of the *distribution, and the other member is not.

Section 207-145 Distribution that is made to an entity

Whole of distribution manipulated

(1) If a *franked distribution is made to an entity in one or more of the following circumstances:

(a) the entity is not a qualified person in relation to the distribution for the purposes of Division 1A of former Part IIIAA of the Income Tax Assessment Act 1936;

(b) the Commissioner has made a determination under paragraph 177EA(5)(b) of that Act that no imputation benefit (within the meaning of that section) is to arise in respect of the distribution for the entity;

(c) the Commissioner has made a determination under paragraph 204-30(3)(c) of this Act that no *imputation benefit is to arise in respect of the distribution for the entity;

(d) the distribution is made as part of a *dividend stripping operation;

then, for the purposes of this Act:

(e) the amount of the *franking credit on the distribution is not included in the assessable income of the entity under section 207-20 or 207-35; and

(f) the entity is not entitled to a *tax offset under this Subdivision because of the distribution; and

(g) if the distribution *flows indirectly through the entity to another entity — subsection 207-35(3) and section 207-45 do not apply to that other entity.

Appendix E: International comparisons

Share Buybacks

International comparison of income taxation (shares held on capital account) — June 2007[77]

The following is a high level summary of the income taxation treatment of share buybacks in selected countries.

Country	Share buyback overview (to investor)		General income tax treatment overview (to investor)	
	On-market share buyback	**Off-market share buyback**	**Capital gains taxation**	**Dividend taxation**
Australia	Capital receipt. Company must make a franking debit as though the buyback had occurred off-market. Income tax measures summarised in ATO Practice Statement PS LA 2007/9.	Split between capital receipt (amount debited to share capital) and frankable dividend (balance of the buyback proceeds). Part may be unfrankable if purchase price exceeds market value. Additional amount may be included as capital proceeds where purchase price is less than market value. Income tax measures summarised in ATO Practice Statement PS LA 2007/9.	Individual Taxable — 50 per cent CGT discount (50 per cent of gain excluded) where relevant interest held more than 12 months. Pension and superannuation funds Superannuation funds are taxable at 15 per cent but a fund paying current pensions is exempt on a portion of income relating to the liabilities to pay current pensions. The capital gains tax in relation to share disposals is reduced by a 33⅓ per cent CGT discount where shares are held for more than 12 months.	Taxed at marginal rates. Full dividend imputation system with refundable excess franking credits. Limitations of availability of imputation benefits if shares do not satisfy the minimum holding period rule and other restrictions noted in PS LA 2007/9.

77 The summary has been provided to the Board of Taxation by Ernst & Young and is for comparison purposes only. Ernst & Young has advised that the information provided is not a substitute for your own detailed research and professional advice which should be obtained from specialists in each jurisdiction.

Country	Share buyback overview (to investor)		General income tax treatment overview (to investor)	
	On-market share buyback	**Off-market share buyback**	**Capital gains taxation**	**Dividend taxation**
US	A redemption of shares may be treated as either a payment in exchange for shares or as a dividend. A share redemption should generally be considered to be a payment in exchange for shares, if the redemption is (1) not equivalent to a dividend, (2) substantially disproportionate[78,] (3) a termination of a shareholder's entire interest or (4) a partial liquidation of a non corporate shareholder. Subject to certain exceptions, the proceeds from a share redemption considered to be a payment in exchange for shares should be treated as a capital gain to the extent that the proceeds exceed the shareholder's adjusted basis in the shares subject to the redemption.[79]	The rules are the same as those for an on-market share buyback.	Individual[80] Net capital gains taxed at ordinary marginal individual income tax rates, however long term capital gains (asset held >12 months) are taxed at 15 per cent (this is reduced to 5 per cent tax if taxpayer is in low income 10/15 per cent rate brackets, and a 0 per cent rate will replace the 5 per cent rate for tax years beginning after December 31, 2007). 50 per cent of the gain from sale of qualified small business shares held for more than 5 years can be excluded from gross income. Pension funds Exempt, subject to certain narrow exceptions	Individual[81] Qualified dividends (which account for most public company dividends) paid by a US corporation or a qualified non-US corporation between January 1, 2003 and December 31, 2010 are taxed at long term capital gains rates (provided that shares were held for more than 60 days in the 120 day period beginning 60 days before ex-dividend date). Other dividends are taxed at marginal individual income tax rates. Pension funds Exempt, subject to certain narrow exceptions

78 The distribution is 'substantially disproportionate' if the ratio which the voting shares of the corporation owned by the shareholder bears to all of the voting shares of the corporation immediately after the redemption is less than 80 per cent of the ratio which the voting shares of the corporation owned by the shareholder bears to all of the voting shares of the corporation immediately before the redemption. (Note that this provision does not apply unless immediately after the redemption the shareholder owns less than 50 per cent of the combined voting power of all classes of shares entitled to vote.)

79 Note that for individuals even dividends may be taxed at capital gains tax rates — see column 4.

80 The rates quoted do not include potential state or local tax rates which may be applicable to these transactions.

81 The rates quoted do not include potential state or local tax rates which may be applicable to these transactions.

Country	Share buyback overview (to investor)		General income tax treatment overview (to investor)	
	On-market share buyback	**Off-market share buyback**	**Capital gains taxation**	**Dividend taxation**
UK	An on-market buyback of shares by a listed company, except in so far as it represents repayment of share capital, is treated as a distribution.	Companies listed on stock exchange An off-market buyback of shares by a listed company, except in so far as it represents repayment of share capital, is treated as a distribution. Special rules for unquoted companies Where specific conditions are met, shares bought back by unquoted trading companies result in the individual shareholder being taxed under the capital gains tax rules rather than under the income tax rules (on a distribution). There is a formal advance clearance procedure to allow individual taxpayers some comfort in respect of the tax treatment in advance of a transaction. For these purposes, shares that are dealt in on the Alternative Investment Market are treated as unquoted.	Individual Capital gains are taxed at the top marginal personal tax rate aligned to savings income (10 per cent, 20 per cent or 40 per cent). The taxable gain can be reduced by taper relief, either business asset[82] taper relief ('BATR') or non business asset taper relief ('NBATR'). The maximum BATR is a 75 per cent reduction in the taxable gain where the asset has been held for 2 or more years and 50 per cent reduction if held for 1 year. The maximum NBATR is a 40 per cent reduction in the taxable gain available after the asset has been held for 10 years (min. 3 years generally required for taper – then 5 per cent per full year). Also an annual capital gains tax free threshold of £9,200 applies (2007/08). Pension funds Exempt	Individual Dividends from UK tax resident companies are paid with a notional non-refundable 10 per cent tax credit. Individuals are taxed on the gross dividend (dividend x 100/90) at their marginal tax rate (either 32.5 per cent or 10 per cent) less the notional tax credit. Individuals taxable at 10 per cent rate will have no further tax liability (10 per cent tax less 10 per cent credit). Individuals who are higher rate tax payers will have additional tax to pay on the dividend (32.5 per cent of the gross dividend less 10 per cent credit). This calculation is the same as 25 per cent of the net dividend. Pension funds Exempt

82 Shares in an unlisted trading company or holding company of a trading group qualify as business assets, as do shares in a listed trading company or holding company of a trading group held by an officer or employee. As do shares in a listed trading company which represent not less than five per cent of the voting rights where the shareholder is not an officer or employee. Shares in investment companies or holding companies of investment groups held by officers of employees can also be business assets as long as the holding (when taken together with shares held by people connected with him) represents not more than 10 per cent, in broad terms, of the company's issued shares or voting rights.

Country	Share buyback overview (to investor)		General income tax treatment overview (to investor)	
	On-market share buyback	**Off-market share buyback**	**Capital gains taxation**	**Dividend taxation**
Singapore[83]	Shareholder The shareholder will be treated as having disposed of the shares. The proceeds received by the shareholder may be taxable as income or capital.[84] If the buyback is effected through special trading counters on the SGX, and to the extent that the payment is not made out of contributed capital of the company, the amount received by the shareholder will be treated as a dividend. This is subject to certain conditions. Note: Contributed capital (a concept for income tax purposes only) the total amount received by company for shares issued reduced by total amount already returned to shareholders which had not been treated as dividend payments. If the company makes the payment out of profits (i.e. not out of contributed capital), the payment will be regarded as a dividend payment.	Shareholder For an off-market share buyback made in accordance with an 'equal access scheme': to the extent that the buyback is not made out of contributed capital of the company, the amount received by the shareholder is treated as a dividend. To the extent the buyback is made out of contributed capital, whether the proceeds received by the shareholder are taxable depends on whether they are income or capital in nature. For a 'selective off-market share buyback', the shareholder will be treated as having disposed of the shares. Whether the proceeds received by the shareholder are taxable depends on whether they are income or capital in nature. If the company makes the payment out of profits (i.e. not out of contributed capital), the payment will be regarded as a dividend payment.	Individual Not taxable if capital receipt. Pension funds As above. No special rules are available.	Individual With effect from 1/1/2003, Singapore changed its imputation system to a one-tier corporate taxation system under which a dividend received by an individual from a Singapore company will be a tax exempt dividend. However, a company can, until 31/12/2007, remain on the imputation system and continue to pay franked dividends, which will be taxable at individual's marginal tax rate with a tax credit for the franking credit attached to the dividend. Any excess franking credit is refundable, other than for share buybacks through a special trading counter on the SGX which qualify for treatment as a dividend in the hands of shareholders. Pension funds As above.

83 A company may buy back its shares out of its capital or distributable profits if the company is solvent. Prior to 30/1/06, on- or off-market share buyback could be made only out of distributable profits.

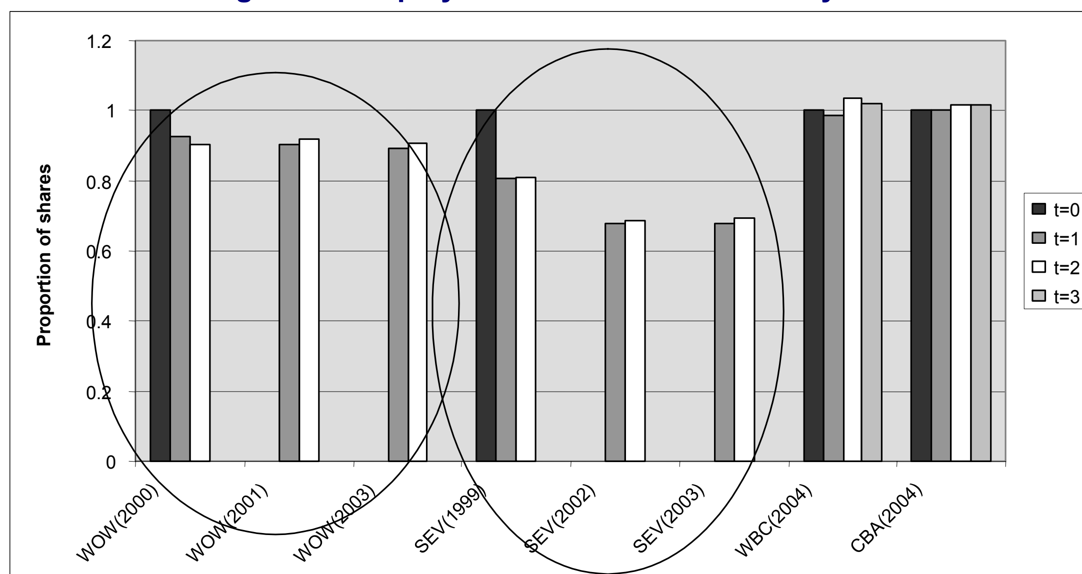
84 If the shareholder is dealing in shares, it is likely that the proceeds will be considered income in nature and therefore taxable. Otherwise the proceeds received will be considered a capital receipt.

Country	Share buyback overview (to investor)		General income tax treatment overview (to investor)	
	On-market share buyback	**Off-market share buyback**	**Capital gains taxation**	**Dividend taxation**
New Zealand	On-market buyback will not be a dividend to shareholder. However, to the extent the amount paid exceeds the available subscribed capital per share, an imputation debit will arise to the company equal to 49.25 per cent of the excess.	Off-market share buyback will prima facie be a dividend. An amount distributed by way of a pro rata, off-market cancellation of ordinary shares is not a dividend where the amount is less than or equal to the 'available subscribed capital cancelled', the cancellation results in at least a '15 per cent capital reduction' (10 per cent with Commissioner approval), and the amount is not in lieu of a dividend (applying certain factors). If, however, the buyback is in lieu of dividends and/or available subscribed capital is depleted, all or part of the buyback amount may revert to being taxable as a dividend.	Individual Capital gains on NZ shares and certain Australian shares are not taxable. Pension funds Capital gains on NZ shares and certain Australian shares are not taxable. There is no general exemption for pension and superannuation funds. To the extent that funds hold shares on revenue account, gains are subject to tax at 33 per cent. However gains on NZ and certain Australian shares will, from 1 October 2007, not be taxable for funds which constitute 'portfolio investment entities'.	Individual Taxed at marginal rates. Dividend imputation system operates (no refundable credits but excess credits carried forward). Resident withholding tax and credit system (withholding tax reduced for imputation credits attached and excess tax refundable). Pension funds All income taxed at 33 per cent (subject to dividend imputation). Tax rate will reduce to 30 per cent from 1 April 2008.

APPENDIX F: IMPACT OF OFF-MARKET SHARE BUYBACKS ON EQUITY LEVELS[85]

Whether buybacks are being used to reduce equity can be assessed by investigating equity levels after the buyback has been completed. To do this, the ratio of the number of shares outstanding after a buyback is completed (t=1, 2, or 3 years after the buyback year) to the number of shares outstanding when the first buyback is announced (t=0) is examined. Seven Network Ltd and Woolworths are two examples of companies that have undertaken multiple off-market share buybacks (see Appendix B), circled in Figure F.1. The Figure shows a net shrinkage in the number of shares. The first Woolworths buyback was announced in 2000; two years after the third buyback, the number of outstanding Woolworths shares is around 91 per cent of outstanding shares at the original announcement. The reduction in the number of shares outstanding for Seven Network Ltd is more pronounced. Seven Network Ltd cited 'long-term improvement in EPS' as the reason for its first buyback in 1999, while the reason given for the 2003 buyback was an 'efficient means of returning capital to shareholders as part of the company's ongoing capital management programme'. The more recent buybacks of Westpac Banking Corp and Commonwealth Bank of Australia have not resulted in a subsequent decrease in the number of shares. Two and three years after each buyback the number of outstanding shares has increased.

Figure F.1: Equity levels before and after buyback



85 This appendix is based on material prepared by Associate Professor Christine Brown for the Board of Taxation.

APPENDIX G: SHAREHOLDER PARTICIPATION MODEL[86]

In order to calculate tax rates at which investors would be better off selling shares in the off-market share buyback as compared to selling on-market, the after-tax payoffs of each strategy are compared.[87] Assume that there is a positive dividend component to the buyback price.

The after-tax payoffs for each strategy are given by:

$$MP - \alpha t(MP - CB) = After\ Tax\ Payoff\ (on\ market) \quad (1)$$

$$BB - \left[\alpha t(C - CB) + t\left(\frac{Div}{0.7}\right) - Div\left(\frac{0.3}{0.7}\right) \right] = After\ Tax Payoff\ (off\ market) \quad (2)$$

Notation is as follows:

MP	market price at time share buyback closes
CB	cost base of the shares
t	shareholder's marginal tax rate
BB	buyback price
C	capital component of the buyback
Div	fully franked dividend component of the buyback
α	$= \frac{1}{2}\left(\frac{2}{3}\right)$ for individuals (superannuation funds)

Assume that $BB = xMP$ (if $x < 1$, then a discount is being offered)

---

86 This appendix is based on material prepared by Associate Professor Christine Brown for the Board of Taxation.

87 The following simplifying assumptions are made:
1. Shareholders (individuals and companies) and complying superannuation funds choose the 'discount method' for calculating CGT, which applies a discount of ½ and ⅓ respectively, to the capital gains. It is assumed that the asset has been held for longer than 12 months.
2. Capital losses are assumed to be offset against capital gains immediately.
3. The dividend component of the buyback price is fully franked.
4. No transaction cost differences as a result of designating part of the return of capital as a dividend.
5. No timing differences in the cash flows and all capital gains and losses have immediate tax consequences.

So $C + Div = xMP$, $Cap = xMP - Div$ (3)

The condition under which the after tax returns for the off-market strategy are greater than those obtained by selling on-market is found by substituting equation 3 into equations 1 and 2:

$$MP\,(1-\alpha t) < (\,xMP - Div)(1 - \alpha t) + Div\left(1 - \frac{t}{0.7} + \frac{3}{7}\right). \qquad (4)$$

For individuals $\alpha = 0.5$ and equation 4 after simplifying becomes

$$t[(13/14)Div - (1/2)MP(1-x)] < (3/7)Div - MP(1-x)\,. \qquad (5)$$

Clearly when $x = 1$, that is there is no discount to the market price, and provided the dividend component is not equal to zero, then $t < 0.4615$. With the current top marginal tax rate at 46.5 per cent (including the Medicare levy), shareholders in the top marginal rate are never better off selling into an off-market share buyback (as opposed to simply selling on-market) where the offer price is at a discount to the market price.

Table G.1 give combinations of *Div* and *x* where $[(13/14)Div - (1/2)MP(1-x)] > 0$ and equation 5 is solved to give the marginal tax rate below which investors are better off participating in an off-market share buyback rather than selling shares on-market. For example, if the buyback price was 90 per cent of the market price and the dividend component constituted 70 per cent of the buyback price, an investor with a marginal tax rate below 0.3178 would be better off selling shares via the off-market share buyback. This assumes that all tax credits (both franking credits and the tax benefits of capital losses) can be realised immediately. Providing the buyback does not occur at a discount to the market price, we conclude that top marginal tax payers generally benefit from selling in the buyback. For example, at a 10 per cent premium to the market price and 50 per cent of the buyback designated a fully franked dividend, the break-even tax rate is 0.5987.

Table G1 shows the marginal tax rates of individual shareholders who would be better off participating in an off-market repurchase than selling on-market. The left-hand column shows the percentage of the buyback price that is a fully franked dividend, and *x* represents the buyback price divided by the market price.

Table G1: Breakeven tax rates for individuals

Div(%)	*x* =0.86	*x* =0.9	*x* =1	*x* =1.1
50%	0.134490	0.252427	0.461538	0.598726
60%	0.198324	0.291139	0.461538	0.577586
70%	0.241309	0.317757	0.461538	0.562092
80%	0.272225	0.337182	0.461538	0.550247
90%	0.295530	0.351984	0.461538	0.540899

When the shareholder is a superannuation fund, the discount allowable for CGT purposes is ⅓ when the asset has been held longer than 12 months. In this case, the condition on the marginal tax rate becomes

$$t < \frac{(3/7)Div - MP(1-x)}{(16/21)Div - (2/3)MP(1-x)}, \quad (6)$$

provided $[(16/21)Div - (2/3)MP(1-x)] > 0$. This condition is satisfied for the combination of variables in Table G.2 which gives the conditions under which superannuation funds gain tax advantages through participating in off-market share buybacks. For example, when the buyback price is at a discount of 14 per cent to the market price (x=0.86) and the dividend component is 60 per cent of the buyback price, the superannuation fund is better off selling off-market than on-market. To the extent that an individual or superannuation fund must carry forward capital losses, the tax benefits of selling shares in an off-market share buyback may be diminished (the marginal tax rates in the Tables H.1 and H.2 may be higher).

Table G2 shows the marginal tax rates of superannuation funds which would be better off participating in an off-market repurchase than selling on-market. The left-hand column shows the percentage of the buyback price that is a fully franked dividend, and x represents the buyback price divided by the market price. The shaded region indicates the parameter values under which superannuation funds should participate in the buyback.

Table G.2: Breakeven tax rates for complying superannuation entities

Div(%)	*x* =0.86	*x* =0.9	*x* =1
40%	0.044018	0.261468	0.5625
50%	0.189024	0.336207	0.5625
60%	0.270648	0.381215	0.5625
70%	0.322993	0.41129	0.5625
80%	0.359416	0.432806	0.5625
90%	0.386224	0.448962	0.5625

It is clear from the results of Tables G.1 and G.2 that the current structure of off-market repurchases gives most advantage to shareholders on low marginal tax rates. For not-for-profits and tax exempt charities the condition under which participating in the off-market share buyback is of greater benefit than selling on-market reduces to

$$xMP + \frac{3}{7}Div > MP$$

This condition simply says that the offer price plus the rebated franking credits must be greater than the market price to make tax exempt shareholders better off by participating. With a dividend component of more than 40 per cent and discounts to market less than or equal to 14 per cent, it is easy to show that these institutions are better off participating than selling on the market.

It is clear from the preceding analysis that the taxation treatment and the perceived maximum discount of 14 per cent entail a structure for off-market share buybacks that benefit low taxpaying shareholders. The intuition behind this result is the fact that shareholders are basically trading off capital gains against income that will be taxed at their marginal rate. For high marginal tax rate shareholders, capital gains are treated favourably compared to income tax.

APPENDIX H: EMPLOYEE SHARE SCHEME EXAMPLES

Free shares with buyback price including an unfranked dividend component

In this circumstance, the tax payable by the employee on the buyback of the shares is likely to be the same as it would have been if the shares were sold to a third party. For example, assume an employee receives for free 'qualifying shares' on which tax is deferred. A 'cessation time' occurs on the buyback of those shares for $10,000 of which $7,000 is an unfranked deemed dividend. In this circumstance, the employee is likely to have $10,000 of assessable income ($3,000 of assessable income under Division 13A and $7,000 of assessable income under section 44 of the ITAA 1936), resulting in estimated tax payable on the buyback of the shares of approximately $3,000 (assuming the employee's marginal rate of tax is 30 per cent). This is the same amount of tax that would have been payable by the employee if the shares had been sold to a third party for $10,000 (resulting in Division 13A assessable income of $10,000).

Free shares with buyback price including a fully franked dividend component

In this circumstance, the tax payable by the employee on the buyback of the shares is likely to be less than it would have been if the shares were sold to a third party. For example, assume an employee receives for free 'qualifying shares' on which tax is deferred. A 'cessation time' occurs on the buyback of those shares for $10,000 of which $7,000 is a fully franked deemed dividend. In this circumstance, the employee is likely to have $3,000 of assessable income under Division 13A, $7,000 of assessable income under section 44 of the ITAA 1936, $3,000 of assessable income under subsection 207-20(1) of ITAA 1997 and an entitlement to a franking credit of $3,000, resulting in estimated tax payable on the buyback of the shares of approximately $900 (assuming the employee's marginal rate of tax is 30 per cent). This is less tax than would have been payable by the employee if the shares had been sold to a third party for $10,000 (resulting in tax payable of approximately $3,000).

Discounted shares with buyback price more than acquisition cost

In this circumstance, the tax payable by the employee on the buyback may be more or less than it would have been if the shares had been sold to a third party, depending on the extent the deemed dividend component of the buyback price can be franked, and the employee's marginal rate of tax. For example, assume an employee purchases 'qualifying shares' for $8,000 (being a discount to the then market value of the shares) on which tax is deferred. A 'cessation time' subsequently occurs on the buyback of those shares for the then market value of $10,000 of which $7,000 is a deemed dividend. In this circumstance, the employee will not make any gain or loss on the disposal of the shares under either Division 13A or the CGT provisions, but will have $7,000 of

assessable income under section 44 of the ITAA 1936 (which may or may not result in tax payable by the employee, depending on the extent of franking and the employee's marginal rate of tax). If, instead, the employee had sold the shares to a third party, the employee would have had $2,000 of assessable income under Division 13A.

Discounted shares with buyback price less than acquisition cost

In this circumstance, the tax payable by the employee on the buyback is likely to be more than it would have been if the shares were sold to a third party. For example, assume an employee purchases 'qualifying shares' for $12,000 (being a discount to the then market value of the shares) on which tax is deferred. A 'cessation time' subsequently occurs on the buyback of those shares for the then market value of $10,000 of which $7,000 is a deemed dividend. In this circumstance, the employee will not make any gain or loss on the disposal of the shares under either Division 13A or the CGT provisions, but will have $7,000 of assessable income under section 44 of the ITAA 1936 (which may or may not result in tax payable by the employee, depending on the extent of franking and the employee's marginal rate of tax). If, instead, the employee had sold the shares to a third party, the employee still would not have had any gain or loss on the disposal of the shares under Division 13A or the CGT provisions (highlighting an existing flaw in those provisions), but would not have had an assessable dividend either.

APPENDIX I: TAX AND ANNOUNCEMENT EFFECTS OF OFF-MARKET SHARE BUYBACKS[88]

Some evidence that off-market share buybacks may in general be beneficial is provided by studies of the market reaction to the announcement of the buyback. Figure 5.2 in Chapter 5 shows the average share price response around the buyback announcement date (by calculating for each company announcing a buyback how its stock price changed relative to the market index) from 20 days prior to 20 days after the announcement of the buyback. Day 0 is the announcement day. On average, investors think that buybacks are beneficial. The documented positive response can be taken as evidence supporting the interpretation that there are benefits to the market as a whole as a result of the buyback. The abnormal returns shown for the companies included in the sample used for constructing Figure 5.2 average 1.2 per cent on the announcement date and 0.9 per cent on the day after the announcement. The average abnormal returns are significantly positive on days 0 and 1 and significantly negative on days 4 and 5.

The market is reacting to the announcement of the buyback positively. This observation, taken together with the argument that the benefit of the discount to market price at which the shares are repurchased does not counter the cost of distributed franking credits, implies that there must be other benefits to the buyback. Whatever the benefit is, it seems to outweigh any detriment caused by the distribution of franking credits at a cost to non-participating shareholders.[89]

The relation between the returns and the structure of the buyback can be investigated by running a regression of the cumulative abnormal returns (over the window from announcement date to ex-entitlement date) on the discount to market price at which the buyback is completed. When this regression is run for the same companies used to produce Figure 2, it is found that the cumulative abnormal returns are positively and significantly associated with the discount to market price of the buyback price. This result is consistent with the observation that the abnormal returns observed over the period between the announcement date and the ex-entitlement date are related to the share of the tax gains flowing to participating shareholders, because only companies distributing imputation tax credits are able to buy back shares at a discount to market price. These results suggest that taxes play an important role in the observed abnormal returns in Australia.

---

88 This appendix is based on material prepared by Associate Professor Christine Brown for the Board of Taxation.

89 An alternative argument put by Cannavan, D, Finn, F and Gray, S 2004, '*The value of dividend imputation tax credits in Australia*' *Journal of Financial Economics,* 73, 1, 2004, 167-197 is that the value of franking credits is zero. This would imply that the positive response may arise purely mechanically, because the company is buying back shares at a price below their fundamental value.

Brown and Efthim (2005) developed a model to investigate the extent to which the tax environment in Australia affects the price at which firms are able to repurchase shares. The fundamental relation underpinning the offer price is that the greater the franked dividend component of a buyback, the larger the discount that can be offered. Their model is given by

$$P = \alpha_0 + \alpha_1 \frac{SREP}{TV} + \alpha_2 \frac{SREP}{IO} + \alpha_3 D \qquad (1)$$

with predicted signs $\alpha_0 \geq 0$, $\alpha_1 > 0$, $\alpha_2 > 0$ and $\alpha_3 < 0$.

The dependent variable P is the dollar value of the offer premium divided by the pre-offer share price times the number of shares repurchased. It is the percentage amount by which the repurchase price exceeds the pre-offer share price (calculated as the closing share price ten days prior to the buyback announcement). TV is used to ascertain the normal daily liquidity of the firm's stock. It is calculated by measuring the average daily volume of trading in a company's shares from day t-10 to t-40 and dividing by the number of shares outstanding (at the announcement date, $t = 0$). The positive predicted sign on α_1 is consistent with the notion that the less liquid the stock, the higher the premium that is required for shareholders to tender their shares. The variable IO represents institutional ownership in the company. D is the total dollar dividend paid out as a proportion of the pre-offer share price times the total number of shares repurchased.

Table I.1

Independent variable	Anticipated sign	Coefficient estimate Sample 1
Intercept	+	0.1843*** (0.0035)
SREP/TV	+	0.0150** (0.0121)
SREP/IO	+	-0.0074 (0.6597)
D	-	-0.3401*** (0.0070)
Regression R^2		0.305
Number of companies		29

Results from running the regression in equation (1) are given in Table I.1. Figures in parentheses indicate p-values (*Significant at 10 per cent, **Significant at 5 per cent,

***Significant at 1 per cent). The important conclusion from this analysis is that the size of the discount of the offer price compared to the current share price is significantly related to the proportion of the buyback price that is designated as a franked dividend.

Announcement of an off-market share buyback is, on average, accompanied by significant abnormal returns on the announcement day and cumulative abnormal returns of up to two per cent in the 40 days surrounding the announcement. As expected, the size of these returns is related to the discount to market price at which the buyback is completed. In turn, the discount at which companies are able to complete off-market share buybacks depends on the proportion of the buyback price designated a fully franked dividend. Perhaps none of these results is surprising. They all point to the fact that taxes play a significant role in the current structure of, and market reaction to, off-market share buybacks. The fact that the market reaction is on average positive, leads to the conclusion that on average shareholders are collectively better off as a result of off-market share buybacks. But some shareholders gain more than others.

Volume effects

Desire by low tax rate investors to participate in the buyback may lead to temporary demand pressure following the announcement. We might, therefore, expect that the significantly positive (negative) abnormal returns observed on days 0 and 1 (4 and 5) are associated with abnormal trading activity on those days. Such abnormal trading volumes may lead to temporary price distortions in the market.

To investigate trading behaviour, a measure of standardised abnormal trading volume can be constructed. Figure 5.5 in Chapter 5 plots average standardised abnormal returns around the announcement date. On the announcement day, standardised abnormal volume is over 85 per cent above normal levels and is significant using both parametric and non-parametric statistical tests. It remains positive on day 1 at over 53 per cent above normal levels. The standardised abnormal volume remains positive until four days after the announcement when there is a substantial reduction in trading volume. Using a non-parametric test the standardised abnormal volume becomes significantly negative from day 4 and remains negative (and mostly significant) until day 13.

It is also evident from Figure 5.5 that there is abnormal trading activity prior to the announcement of the buyback. The standardised abnormal volumes observed in Figure 5.5 around ten days before the announcement appear to be the result of anticipatory trading prior to the announcement of the buyback, in situations where the buyback intention has been announced at the previous Annual General Meeting. This has happened in instances of earlier buybacks where there were fewer than 45 days between the announcement and close of the buyback. In these cases investors could purchase the shares and receive the tax benefits from selling those shares into the buyback only by purchasing shares prior to the announcement date. Anecdotal

evidence suggests that anticipatory purchase of shares in companies likely to conduct a buyback may still be prevalent.

By examining trading volume in the period prior to the announcement of an equal access repurchase, direct empirical evidence of abnormal trading behaviour can be provided for a subset of the companies listed in Appendix B. Most instances of abnormal volume occur when the repurchase is structured to pass imputation credits on to participating shareholders. All dates on which abnormal trading behaviour is observed occur at least 45 days before the closing date of the buyback. Five of the seven observations of abnormal trading volume occur for large blue-chip companies at least nine trading days before the announcement of the buyback. Table I.2 lists instances for Commonwealth Bank of Australia (CBA) off-market share buybacks where there is evidence of abnormal trading activity prior to the announcement of the buyback (note that only buybacks up to the end of 2004 have been examined for this analysis).

In addition to the cases of the three CBA repurchases listed in Table I.2, evidence of abnormal trading activity is found for IronBark Capital Limited (IBC-BT Australian Equity Management Ltd) seven days before the announcement and for Telstra (TLS) nine days before the announcement. The returns to institutional investors in these cases are lower than in the CBA cases, but are still sizeable. Of all the instances of abnormal trading activity IBC is the only case with volume around the announcement date lower than normal.

In Table I.2, volume is measured as the logarithm of one plus the daily trading volume. Abnormal volume is the standardised measure of abnormal volume. Standardised abnormal volumes greater than 2.5 in the 20 days prior to the announcement of the buyback are documented in column 4, and the number of days prior to the announcement day on which they occur are listed in column 5. If the logarithm of daily volumes is normally distributed, then an observation of a standardised abnormal volume greater than 2.5 should occur only with probability around 0.0062. Annual returns are calculated for institutional investors on marginal tax rates of 15 per cent and 30 per cent (in columns 6 and 7 respectively), assuming that the shares were purchased the number of days before the announcement and tendered in the repurchase. These calculations include the tax rebates on franking credits. Daily closing prices are used to calculate returns.

Table I.2: Abnormal trading activity prior to announcement of the buyback

ASX Code	Date announced	Days 0 to close	Abnormal volume	Days pre-announcement	Return per cent pa (t_p=0.15)	Return per cent pa (t_p=0.30)	Days (purchase to close)
1	2	3	4	5	6	7	8
CBA	12-Nov-97	37	2.547	-15	162.0	133.4	52
		37	3.530	-11	282.0	232.2	48
		37	2.845	-10	220.0	181.2	47
		37	4.009	-8	212.9	175.4	45
CBA	10-Feb-99	37	3.598	-8	192.2	158.3	45
CBA	13-Feb-01	45	3.732	-11	63.6	52.4	56
CBA	11-Feb-04	44	2.731	-8	79.4	65.4	52

Investors buying shares on the days prior to announcement listed in column 5 of Table I.1 satisfy the 45-day trading rule (as can be seen by the day count in column 8). This rule requires investors to hold the shares for at least 45 days (not including the purchase date and the resale date) to be eligible for the franking credits attaching to the dividend component of the buyback.

An explanation for the abnormal trading volume documented in Table I.2 (and for the other cited cases) is that in all these cases the company gave warning of an impending buyback to shareholders in the AGM preceding the buyback. An examination of the information publicly released in these cases does not provide details of the exact structure and date of the up-coming buyback. Nevertheless, informed investors may have been able to surmise likely structure of the buyback and approximate date and have bought shares in anticipation. The foregoing projected returns from trading prior to the announcement of the buyback are based on a simplified analysis with a number of assumptions that do not take account of the fact that the strategy of buying prior to announcement and tendering those shares into the buyback is not riskless. Nevertheless, the evidence presented supports the contention that there may be some distortions to prices and market activity caused by tax induced trading around the announcement of an off-market share buyback. This is further corroborated by the observation that in all but one of the cases presented in Table I.2 there was not sufficient time between announcement and close of the buyback to buy shares to tender in the buyback and claim the franking credits.

APPENDIX J: MODEL FOR ASSESSING EQUITY ISSUES[90]

The market value of a company which has a stock of undistributed franking credits can be viewed as consisting of two components. First, there is the value attributable to future cash flows (including generation of new franking credits) of the company. Second, there is the value attributable to the market valuation of the existing currently undistributed stock of franking credits. To simplify the analysis assume that the buyback is of the fixed price type.

Assume that the company has (n_c + n_n) shares on issue at a current market price of p, where n_c are those held by shareholders on low tax rates who value franking credits and will participate in a buyback, and n_n are those held by shareholders on high tax rates who do not wish to participate.

The value of the company is:

$$V = p(n_c + n_n) = V_A + \gamma_u FC \quad (1)$$

where V_A is the value of the company ignoring its stock of undistributed franking credits, FC is the stock of undistributed franking credits of the company, and γ_u is the market valuation of undistributed franking credits.

The buyback at a discount to market price of \$x with some part of the buyback deemed to be a franked dividend involves the purchase of α of the n_c shares at a price of (p-x) and involves distribution of β of the franking credits. The aggregate discount on shares repurchased is $x\ \alpha\ n_c$ and the market valuation of franking credits distributed is $\gamma_d\ \beta$ FC, where γ_d is the market valuation of distributed franking credits. It is assumed that the announcement of the buyback does not convey any information to the market which would cause a change in V_A. In practice such an announcement will have valuation effects (which is discussed in a later section) – but the objective of this analysis is to assess the effects of the type of buyback on different groups of shareholders.

After the buyback, the company value is reduced by the cash outflow and decline in undistributed franking credits to V*:

$$V^* = V_A - (p\text{-}x)\ \alpha\ n_c + \gamma_u(1\text{-}\ \beta\ )FC \quad (2)$$

Substituting for V_A from equation (1) gives:

$$V^* = p(nc + nn) - (p\text{-}x)\ \alpha\ nc - \gamma\ \beta\ FC \quad (3)$$

With n_n + (1- α) n_c shares now on issue, the new share price is:

90 This appendix is based on material prepared by Associate Professor Christine Brown for the Board of Taxation.

$$p^* = p + (x\,\alpha\, n_c - \gamma\, \beta\, FC)/(n_n + (1-\alpha)\, n_c) \qquad (4)$$

which is greater than p if the aggregate discount ($x\,\alpha\, n_c$) is greater than $\gamma_u\, \beta$ FC.

Non-participating shareholders will benefit if the aggregate discount is higher than the market valuation previously given to the franking credits which have now been distributed. In that case the market price of their (unchanged number of) shares will have increased. They will be worse off if the aggregate discount is less than the market valuation previously placed on the franking credits distributed, causing a fall in the share price.

The outcome for participating shareholders appears somewhat more difficult to assess, since they will have sold only a fraction (α) of their shares into the buyback. It would thus appear possible that in cases where the share price falls, they could be overall worse off, due to the decline in value of their remaining shares. However, for such shareholders, it is necessary to consider the after-tax position, which includes the tax benefits arising from deemed capital losses and franking credits generated by the buyback. Since the buyback triggers an overall reduction in tax liabilities to the cost of the government, shareholders in aggregate must be better off. Thus, if non-participating shareholders are worse off, those who participate must be better off.

This analysis shows that, abstracting from information effects, the share price will be higher after a buyback if the aggregate value of the buyback discount exceeds the prior market valuation of the franking credits distributed. The intuition is straightforward. The value given up by remaining shareholders is less than the benefit received from the company repurchasing (and cancelling) shares at a below-market price.

For example, if 1,000 shares are bought back at a discount of $1.00 per share and there are $1,200 of franking credits distributed which the market values only at, say, $600, the remaining shareholders are $400 better off and the share price will increase.

Thus, to assess the impact of buybacks on non-participating shareholders, and the equity implications of their design, we need information for each buyback on the aggregate discount involved, the total of franking credits distributed, and the valuation factor γ_u associated with undistributed franking credits.

Table J.1 provides information on the aggregate discount and total of franking credits distributed for the buybacks listed in Table 5.1 in Chapter 5. It can be seen that if undistributed franking credits are fully valued by the market ($\gamma_u = 1$), non-participating shareholders were in all cases worse off. The total of franking credits far exceeds the aggregate discount involved. For the equal access repurchases listed in Table J.1 the total aggregate discount (using the announcement date share price) is $1,465.8 million and the franking credits distributed total $4,931.1 million.

Table J.1: Aggregate discounts and franking credit distributions

ASX code	Date announced	Amount spent ($m)	Total discount ($m)	Franking credits ($m)
CBA	12/11/1997	650.63	-0.38	164.56
CBA	10/02/1999	650.77	28.19	173.35
SEV	11/03/1999	325.00	-39.00	0.00
WYL	17/05/1999	28.98	-0.44	7.22
CBA	30/09/1999	553.14	-58.33	0.00
WOW	14/02/2000	491.96	20.00	105.85
LLC	18/08/2000	1754.94	46.79	487.29
ANN/PDP	02/10/2000	163.19	-2.04	0.00
CBA	13/02/2001	699.96	54.31	192.23
IAG	02/03/2001	404.16	10.40	59.86
BOQ	06/04/2001	24.97	-0.74	5.47
WOW	30/04/2001	348.21	11.21	99.83
TAB	21/03/2002	134.01	3.42	8.17
IAG	06/05/2002	298.47	38.16	53.26
SEV	27/08/2002	193.87	-23.40	54.01
WOW	24/02/2003	531.91	-6.07	170.37
TLS	03/10/2003	1000.57	188.20	275.67
SEV	24/10/2003	193.87	-0.33	33.23
FGL	06/11/2003	668.43	63.50	156.84
MAY	30/01/2004	359.69	-35.46	0.00
CBA	11/02/2004	532.42	81.12	136.91
IAG	30/04/2004	413.96	43.28	105.64
WBC	06/05/2004	558.58	112.10	173.35
TLS	27/09/2004	750.40	120.43	202.49
BHP	05/10/2004	2271.61	410.23	810.90
ANN	12/10/2004	155.00	-3.20	0.00
BSL	23/02/2005	200.39	41.63	51.86
CXP	01/03/2005	35.28	3.72	14.31
CML	17/03/2005	584.60	95.79	159.99
WBC	02/11/2005	1000.00	72.14	338.96
SGB	16/12/2005	300.00	40.40	95.84
BHP	15/02/2006	2250.05	86.36	877.95
CML	23/05/2006	836.98	91.65	253.55

Note that a negative figure for the discount column indicates that the company completed the buyback at a premium to the announcement date share price.

The other piece of information needed to complete the analysis, the franking credit valuation factor (γ_u), is highly contentious. Empirical studies have led to conflicting results that place the value of γ_u at anything from close to unity to close to zero.[91] A recent study using Australian Tax Office data shows that a reasonable estimate over the period 2001 to 2004 is 0.81.[92] Access pricing regulators (such as the ACCC) attempting to determine the cost of capital for regulated industries have tended to adopt a value of around 0.5.

If franking credit valuation is 50 per cent (so that the market valuation of franking credits is obtained by dividing the last column of Table 5.1 by two) the story is somewhat more mixed, but non-participating shareholders are still worse off in the majority of cases. Thus, the calculation of the wealth lost by non-participating shareholders as a direct result of the off-market share buyback depends on the market valuation of undistributed franking credits.

Moreover, it can be shown that the benefit to shareholders not participating in a buyback increases with the size of the price discount involved in the buyback, and that the (now common) tender system used for determining that discount has led to discounts smaller than might be expected in a competitive market.[93]

It is important to note that the analysis in this appendix has ignored information effects arising from the announcement of the buyback.

---

91 Walker S and Partington, G 1999, '*The value of dividends: Evidence from cum-dividend trading in the ex-dividend period*', *Accounting and Finance*, 39, 275-296; Cannavan, D, Finn, F and Gray, S 2004, The value of dividend imputation tax credits in Australia *Journal of Financial Economics,* 73, 1, 2004, 167-197.

92 Handley, J and Maheswaran, K 2007, '*A Measure of the Efficacy of the Australian Imputation Tax System*' Unpublished.

93 Brown, C and Davis, K 2007, '*Share buybacks and shareholder equity*' Working paper.