



Your Health & Community
Services Industry Fund

24 August 2007

via email: taxboard@treasury.gov.au

Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

Review of the Taxation Treatment of Off-Market Share Buybacks

H.E.S.T Australia Limited the trustee of the HESTA Super Fund (HESTA) is pleased to make a submission to this review by the Board of Taxation. Approximately 32% of assets, or \$4 billion, are invested in companies listed on the Australian Stock Exchange through externally managed portfolios.

HESTA believes that off-market share buybacks are a valuable mechanism by which companies can distribute excess capital to their shareholders in an efficient manner. The efficiency of capital markets is of significant importance to a continuation of the economic prosperity that Australia has experienced over the last 15 years. Economic growth, taxation revenue, and the living standards of all Australia's citizens will be enhanced if capital is allocated to its most productive use. Off-market share buybacks facilitate the movement of capital in a relatively free manner to more productive uses.

HESTA is largely in favour of the current rules that apply to off-market share buybacks and provides the following comments on the detail of the taxation arrangements:

Equity between participating and non-participating shareholders

The progressive nature of the income tax system means that off-market share buybacks will be more attractive to investors with lower marginal tax rates, and those that are tax exempt but can utilise the benefit of franking credits received. The community expects the government of the day to assist lower income earners, charitable organisations, and all citizens in their accumulation of retirement savings through superannuation. This is an intentional consequence of a progressive income taxation system.

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It is clear that all shareholders benefit from off-market share buybacks. Those that rationally participate, do so from the superior after-tax value received from successfully tendering their shares into a buyback relative to holding their investment through the buyback period. The price at which it is rational for a shareholder to participate in a buyback is dependent upon their individual tax circumstances.

Shareholders who do not participate in a buyback benefit from the higher share price that should result from the increase in earnings per share of the company.

Significant debate exists about whether there is a disproportionate transfer of company value from non-participating to participating shareholders. It is difficult to determine whether this problem really exists, however it would be simple to remove the perception of the problem.

If the Board of Taxation concludes equity is a problem then they should recommend that the 14% cap on the buyback discount be removed. The market could then determine what a fair price is for participation in the buyback thus ensuring all shareholders are treated equitably.

Protection of taxation revenue

The discussion paper issued by the Board of Taxation advises that one of the outcomes of the principles underlying the imputation system is that there will be shareholders (predominantly non-residents) who cannot utilise imputation benefits received from franked distributions. The wastage of these benefits is a design feature of the imputation system. The buy-back process does not impact on the taxation revenue received from the company, which is already paid and gives rise to the franking credit, it is the use of the resulting credit, or more accurately wastage of the credit, where buy-backs may have impacted on overall Treasury revenue.

The use of the general anti-avoidance provision contained in section 177EA of the Income Tax Assessment Act by the Commissioner is an important measure that ensures the design of the imputation system is not compromised and taxation revenue is protected. The Commissioner has the discretion to debit the franking account of the company undertaking the off-market share buyback, for the avoided wastage of imputation benefits, when he concludes that one of the effects of a buyback is the streaming of franked dividends from non-resident to resident shareholders.

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The use of section 177EA by the Commissioner means that off-market share buybacks are broadly revenue neutral to Treasury as the value of franking credits paid out should be equivalent to that distributed by way of a dividend. HESTA reiterates that Treasury has already received the taxation revenue through the payment of company tax. The franking credits associated with the tax already paid by the company are an asset of the shareholders of the company.

Importantly the estimates of tax expenditure arising from off-market share buybacks contained in the discussion paper do not take account of the debit made to the franking account of companies under the anti-avoidance provisions. HESTA urges Treasury to improve the methodology they employ to estimate this level of tax expenditure as the current published figures are misleading, and of little use to stakeholders.

Capital/Dividend split

HESTA notes the following 3 methodologies as being deemed acceptable by the tax office to determine the capital/dividend split of an off-market share buyback:

- Average capital per share
- Share capital to retained earnings
- Embedded value

HESTA does not hold a strong view as to whether one method is superior to the others. It is important though, regardless of whether one or all three are recommended by the Board of Taxation to be acceptable, that the accepted methodologies are specified in the law to provide clarity to stakeholders.

Administrative processes

The current administrative process by which companies undertake off-market share buybacks is cumbersome and potentially detrimental to capital markets efficiency.

Given the general uncertainties and potential liabilities regarding the tax consequences of transactions it is not surprising that companies seek private binding rulings from the tax office as part of their process when undertaking buybacks.

If the administrative arrangements could be streamlined by specifying the tax office's practices regarding off-market share buybacks into law then it would be

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beneficial for all stakeholders. This would reduce the need for tax rulings, the necessary preparation time for transactions, and improve the operation and competitiveness of Australia's capital markets.

Summary

HESTA believes that the off-market share buyback is a valuable capital management tool that allows Australia's capital markets to maintain their competitive position within global markets.

It is a tool that improves economic growth, employment, taxation revenue, and the living standards of all Australians through the benefits gained by the efficient allocation of capital amongst competing uses.

The current taxation arrangements are largely equitable so HESTA urges the Board of Taxation to limit recommending changes, if any, to the simple measures we have discussed.

A focus of the review should be to reduce the administrative burden imposed on companies that undertake off-market share buybacks by recommending that the Government enshrines acceptable practices into law.

HESTA thanks the Board of Taxation for the opportunity to present this submission to their review of the taxation treatment of off-market share buybacks.

Yours sincerely

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