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

Dear Sir

REVIEW OF THE TAXATION TREATMENT OF OFF-MARKET SHARE BUYBACKS

Thank you for the opportunity to provide a submission to the Board's review into the tax arrangements relating to off-market share buybacks.

The Australian Securities Exchange Ltd (ASX) understands that, in general, the existing off-market buyback tax arrangements are working satisfactorily and is not aware of any case for significant change. There seems to be little evidence that there are significant problems with the existing arrangements or that they have created opportunities for tax mischief. However, there may be scope for relatively minor administrative changes that could reduce compliance costs, for both listed companies and the ATO, and speed up the tax ruling process.

Over the years, off-market buybacks have become an important element of Australian companies' capital management toolbox, even if capital returned through this mechanism remains relatively small compared to total capital distributed to shareholders through other routes, such as ordinary dividends.

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

A sustained period of strong earnings growth over the past few years in Australia, combined with a relatively conservative approach by Australian corporations to their gearing ratios, has seen a rise in the quantum of capital returns to shareholders. As such, the increase in capital returns can be seen as largely a cyclical response to very healthy economic conditions.

A company's Board of Directors and its management are charged with the responsibility of acting in the best interest of the company (and its shareholders) as a whole, including in the choice of the means of distributing excess capital. They are best placed to determine the most appropriate mechanism for the return of capital to shareholders that maximises both the returns for shareholders while ensuring the company is positioned to prosper into the future.

Tax treatment is clearly an element driving the decision to undertake an off-market buyback structure. However, while off-market buybacks are now the second most popular capital return mechanism, after ordinary dividends, the fact that a large number of companies choose a range of alternative strategies (eg increasing ordinary dividends, paying special dividends, or conducting on-market buybacks) suggests it does not suit all circumstances.

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SFE Clearing Corporation

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Over a ten year period the average number of companies making off-market buybacks each year has been five, which is only a very small fraction of the total number of listed Australian companies (which now number around 1,900). While the numbers have been on the rise in recent years, both in terms of the numbers of companies undertaking buybacks and the value of shares repurchased, as noted above this has largely reflected particularly strong economic conditions and company profits.

The paper does not suggest that Directors have not been discharging their responsibilities to shareholders in their choice of capital management instrument. It is worth noting that companies usually repurchase a relatively small proportion (around 5 per cent) of outstanding securities through a buyback so Directors would be particularly sensitive to the interests of the remaining shareholders who will continue to hold the remaining 95 per cent of outstanding equity.

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

There was no indication in the discussion paper of any particular mischief in the area of the tax treatment of off-market buybacks that needs to be addressed. While there were some concerns expressed around possible dividend streaming, for example, it would seem there are enough existing mechanisms available to the ATO to deal with this situation if it is a concern, including the general dividend streaming rules and debiting a companies franking account to compensate for any identified streaming of dividends.

One area that the discussion paper highlighted as a possible concern was the spike in equity trading immediately after the announcement of a buyback, and a similar spike that occurs around ten days prior to the announcement.

This anticipatory and post-announcement trading reflects investors adjusting their portfolios depending on the attractiveness to them of the buyback proposal. Some investors will seek to buy securities to take advantage of the offer, while others sell because the buyback structure is less attractive to them.

It is unclear what particular problem is caused by this trading activity.

While some argue that investors shouldn't be able to buy-in to a stock in order to participate in a buyback, because existing shareholders 'own' the franking credits the fact remains that different shareholders value the franking credits differently and should be free to sell their shares to those who value those credits more. This is no different to trading that may occur around the record date for the payment of ordinary dividends. As noted above, if there is a concern that this trading is facilitating dividend streaming there are existing options available to the ATO to deal with this situation.

We note the Board of Taxation's paper suggested that one possible option to reduce this trading activity would be to deny franking credits to shareholders who entered into a contract to buy shares less than four days before and in the period immediately after the buyback announcement.

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

In any event, such an artificial cut-off period is unlikely to significantly affect the trading spike – it would be more likely to just move it forward a few days. As noted in the paper there is already a peak in trading well in advance of the announcement reflecting the markets assessment of the probability of a buyback announcement being made, based on previous indications from the company and the knowledge that any announcement would coincide with the scheduled release of financial results. Any change in arrangements to reduce anticipatory trading may merely increase the earlier spike at the expense of the post-announcement spike.

If such a scenario played out, knowledgeable investors who wished to trade would arrange to trade in advance of any cut-off period while unknowledgeable investors may buy in the few days before an announcement and be denied the use of the franking credits if they wished to sell into the buyback.

We understand that some have argued that changing other design features of the tax treatment of buybacks, such as removing the cap around the price discount, may help to reduce the anticipatory trading by increasing the risks associated with participation in the buyback.

In conclusion, the Board of Taxation's discussion of the tax treatment of off-market buybacks is an excellent exposition of the facts and policy issues surrounding this sometimes controversial topic. We believe off-market buybacks are an important capital management option available to companies that wish to return excess capital to its shareholders.

ASX considers that the existing tax arrangements around these transactions are working satisfactorily, with no real indication that they are causing particular problems. While some relatively minor changes may reduce the compliance costs for both the ATO and the companies undertaking these transactions, ASX believes no significant change to existing arrangements are required.

Yours sincerely

A handwritten signature in black ink that reads "Malcolm Starr". The signature is written in a cursive, flowing style.

Malcolm Starr
General Manager
Regulatory and Public Policy