



30 August 2007

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

Dear Sir/Madam

Review of the Taxation Treatment of Off-Market Share Buybacks

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Board's review of the taxation treatment of off-market share buybacks. The Discussion Paper considers various options for improvement to the tax law as well as administrative practice relating to off-market share buybacks, which has the potential to achieve a greater level of certainty for companies, shareholders and the Australian tax authorities.

AFMA represents participants in the wholesale banking and financial markets. Our member firms include the leading corporate finance advisers to major listed companies, as well as the major listed financial institutions who may return capital via off-market share buybacks from time to time. Whilst AFMA members may approach the issues raised in the Discussion Paper from those varying perspectives, all members have a vested interest in promoting the efficiency of capital markets and the financial markets more generally.

As outlined in the Discussion Paper, changes to the corporations law since 1989 and subsequent amendments to tax law and practice to mirror these changes reflect the importance placed on an effective mechanism for capital return. The ability of companies to return capital to shareholders is not only a prerequisite for effective capital management, but also essential in allowing investors to maximise the value of their investments. An efficient capital return mechanism gives investors greater choice in the allocation of their funds, particularly where the capital they have invested in a company is not being utilised effectively.

Off-market share buybacks are a popular choice for companies, because they are relatively quick to execute and not dependent on the liquidity of the company's shares on the Australian Securities Exchange (ASX). The current tax treatment of off-market share buybacks allows surplus franking credits to be distributed to those shareholders who value them most. This in turn increases the company's ability to realise an optimal buyback price, often at a discount to market. Therefore, the progressive tax treatment of off-market share buybacks is a significant feature that enhances the efficiency of capital return by this method.

It has been argued that off-market share buy-backs are unattractive to some shareholders relative to others as a result of the way tax is applied, and results in an inequitable and discriminatory outcome. Such an argument, while focusing on a particular sub-set of shareholders seems to ignore the benefits associated with buybacks for the company as a whole, and therefore, benefits for non-participating shareholders. In addition, the tax system treats some shareholders differently from others and, as noted by the Australian Securities and Investments

Australian Financial Markets Association

ABN 69 793 968 987

Level 3, 95 Pitt Street Sydney NSW 2000 Tel: (61 2) 9776 7955 Facsimile: (61 2) 9221 8156

www.afma.com.au

Commission (ASIC), off-market buybacks illustrate this inequality, but do not create it.¹

In considering the policy benchmarks that will determine the appropriate taxation treatment, the Board should have regard to the non-tax benefits that are associated with off-market share buybacks, rather than benchmarking the equity objective with regard only to tax outcomes.

We expect that members who have an interest in the review may be submitting comments to the Board individually. Our members are well placed to comment on the consultation questions surrounding the purpose of and alternatives to off-market share buybacks, as well as developments in the market. Within this context, we would like to support UBS's submission, which outlines the salient points in this regard. Rather than repeating this comprehensive analysis, we will limit our comments to the assessment of the current taxation treatment (chapter five) and the associated proposals. Members' interest in the review also does not extend to implications for unlisted companies undertaking off-market share buybacks, so we have not addressed these aspects of the Discussion Paper.

1. Efficiency/Neutrality

Better Allocation of Resources

5.1 Do off-market share buybacks lead to efficient economic outcomes?

As noted in the Discussion Paper, one of the reasons companies undertake share buybacks is to return capital that is surplus to the needs of the company. In these instances, a return of capital would lead to efficient economic outcomes, as the capital that is not being utilised effectively is freed up for shareholders to pursue alternative investments that may yield higher returns. As an efficient means of returning capital, off-market buybacks are a significant feature of the equity market, which enhances the options available to investors in making their allocation decisions.

The various reasons companies undertake share buybacks have been identified in the Discussion Paper. The primary objective underlying the purpose of any share buyback is to maximise value for the company and its shareholders. Capital return by way of an off-market buyback is generally seen to be the best method of increasing earnings per share (EPS) post transaction, and therefore, value for non-participating shareholders. As such, not only are off-market buybacks beneficial because participating shareholders can allocate their resources more effectively, benefits also flow to non-participating shareholders.

5.2 If so, do they do so more efficiently than other mechanisms for returning surplus cash?

5.3 Why are they more efficient?

5.4 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 are more efficient than other capital return methods in achieving economy-wide benefits. The acknowledgment in tax law that consideration for a share buyback can be sourced from profit as well as capital allows franking credit benefits to flow to participating shareholders and this is a significant consideration.

¹ ASIC media release 05-44 'ASIC's position on off-market share buybacks incorporating fully franked dividends', 3 March 2005.

Consequently, the current tax treatment allows companies to buy back shares at a discount to market price, as shareholders who value the tax benefits are likely to participate despite the discounted price. Buying back shares at a discount would allow companies to repurchase more shares relative to on-market buybacks, so that the benefit not only flows to participating shareholders who can better allocate their resources, but also to the company and non-participating shareholders who benefit from the positive impact on EPS.

The discounted repurchase price is only a feature of off-market buybacks. Without the tax benefits associated with off-market buybacks, shareholders are unlikely to accept a buyback price on-market that is at a discount to market price. In addition, unlike on-market buybacks, there are no transaction costs (ie brokerage fees) for participating shareholders in the disposal of their shareholdings.

Increasing dividends and special dividends are also effective methods in returning surplus capital, but they have a negative impact on EPS, and therefore no post transaction value for the company and shareholders. Whilst share buybacks are longer term strategies focused on creating value for the company, capital return by way of increased dividends may not be sustainable and special dividends are one-off benefits without any focus on generating value for the company over the longer term.

Optimal Use of Franking Credits

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

Yes. Franking credits arise from the payment of tax by the company. The optimal use of franking credits is appropriate particularly where companies hold large franking credit accounts that are in excess to the needs of their ordinary dividend policy. In many cases, off-market buybacks give companies the opportunity to distribute surplus credits in a way that creates value for shareholders.

Moreover, the relative value of surplus credits is not the same for all shareholders. In all likelihood, shareholders who do participate in a buyback would benefit more from the franking credits distributed as a result of that transaction, relative to non-participating shareholders. Non-participating shareholders who cannot use, or fully use the credits would not actually be disadvantaged by the distribution of the surplus credits. In addition, surplus franking credits that are 'trapped' and cannot be distributed other than through an off-market share buyback have limited value.

5.9 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?

Off-market share buybacks will result in some shareholders receiving franking credits, and others not. Over time, this may indeed result in the unequal distribution of franking credits. However, this outcome is the result of shareholder choice, and not an actual differential treatment of shareholders. For off-market buybacks, all shareholders are given the choice to participate and therefore receive franking credits distributed.

The imputation system has been designed to provision for the wastage of franking credits to take into account credits that cannot be used or fully used by some shareholders. There are many factors that mitigate the impact of the optimal use of franking credits on tax revenue. Franking debits by the ATO under the

imputation benefit scheme rule (s177EA) in relation to non-resident streaming provides some benefit to taxation revenue. Most importantly, value creation from successful buyback transactions creates economically efficient outcomes in the longer-term, having a positive impact on taxation revenue.

It should also be noted that the opportunity for companies to enable the optimal use of franking credits is limited. Off-market share buybacks are significant activities for companies to undertake. The decision to undertake a buyback is made only after the significant costs and effort of a buyback are assessed against the expected benefits. For most companies, the repurchasing of shares is an infrequent occurrence. Within this context, impact on taxation revenue on a company-by-company basis is insignificant. In aggregate, surplus franking credits that are never utilised, therefore providing a benefit to tax revenue, will balance any effect of off-market buybacks.

Distortions between Different Mechanisms

5.10 What are the advantages and disadvantages of these approaches?

The Discussion Paper outlines two alternative approaches that would increase the comparability of tax treatment for on and off-market share buybacks. The targeted benefit of these approaches is tax neutrality between the different capital return methods. However, both options would penalise shareholders who receive the CGT discount and/or who cannot utilise capital losses. Therefore, the approaches considered would not remove tax as a consideration, as it would still influence shareholder choice and shape the optimal approach to capital management by companies.

2. Equity

Non-Participating Shareholders

5.13 Do non-participating shareholders benefit from off-market share buybacks?

5.14 Under what conditions would this be the case?

Yes. There is a strong correlation between benefits that would flow to non-participating shareholders and consideration paid for the share repurchase. Generally, a greater discount to market price enhances value for non-participating shareholders by generating a higher EPS outcome post transaction.

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

AFMA agrees with UBS's view that off-market share buybacks should generally have no impact on the ability of companies to frank future dividends. The indications are that companies that have undertaken off-market buybacks continue to distribute fully-franked dividends.

5.16 Does the market attribute value to franking credits?

The value of franking credits can not be assessed without consideration of factors specific to individual companies, such as the amount of credits in the franking credit account and dividend policy. The value of franking credits is not only different for shareholders on varying tax margins, but will also depend on the likelihood of those credits being distributed. Surplus franking credits without much prospect of distribution are not valuable to any shareholder.

5.17 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?

As outlined in the Discussion Paper², non-participating shareholders can benefit from an off-market share buyback, especially where it has a positive impact on EPS. In this context, we believe the removal of the 14 percent cap on an acceptable level of discount would increase the potential benefits for non-participating shareholders. Currently, the 14 percent cap limits the size of the discount that can be applied to the repurchase price, which also reduces the potential benefit to non-participating shareholders.

Implications of the 45-Day Rule

5.18 Should investors be able to buy shares following the announcement of a buyback and participate in the buybacks?

AFMA recommends maintaining the status quo and, in this context, we note the effect of the 45 day rule as a revenue protection measure. Anticipatory trades fulfil a useful function by providing liquidity for those shareholders who do not want to participate in the buyback. In addition, there are risks to trading strategies based on anticipatory tax benefits, which limits anticipatory trading activity to some degree. These risks would be amplified if the current 14 percent cap on the level of discount is removed.

Implications of the Level of Discount

5.20 In what circumstances should section 177EA apply?

AFMA concurs with UBS's view that s.177EA should apply in circumstances where a scheme is designed to distribute franking credits to entities which have no real economic exposure to or interest in the underlying profits, or where a scheme is designed to artificially generate franking credit distribution to particular entities.

If the current 14 percent cap on the acceptable level of discount is removed, ATO guidance should clarify the instances in which the Commissioner's discretion to deny imputation benefits to shareholders under s177EA(5)(b) will be exercised.

5.22 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?

5.23 If a cap should be retained, is 14% an appropriate maximum level of discount to deny franking credits to participating shareholders? If not, how should the acceptable level of discount be determined?

The ATO's Practice Statement (PS LA 2007/9) states that the maximum acceptable level of discount in a tender process buyback is 14 percent, without further clarification to how this cap has been determined and the basis for it. We do not see a basis for a cap, but if one is to be retained, there should be a clear rationale for it and greater transparency on how it has been determined.

Moreover, we note that higher discount rates are likely to generate value for non-participating shareholders. We believe market forces produce more efficient pricing outcomes than an arbitrary cap set without regard to the circumstances of individual transactions.

5.24 Should franking accounts be debited for resident to resident streaming? If not, why?

5.25 If so, what would be an appropriate methodology for calculating resident to

² As summarised in paragraph 4.19.

resident streaming?

5.26 How could the Tax Office identify company shareholding patterns?

5.27 Would it be appropriate to use some proxy measure to overcome timing difficulties?

5.28 How could nominee issues be dealt with?

Franking accounts should not be debited for resident-to-resident streaming. As a general principle, regulation should only be applied if there is a demonstrated need for it, and the benefits of regulation would outweigh the associated costs. Resident-to-resident streaming is a consequence of the progressive nature of the tax system and its application to company distributions, rather than a failure of the imputation system *per se*.

In addition, there are practical difficulties in identifying the shareholding patterns of a company that would enable the calculation of franking credits to be debited, because companies do not know the tax profiles of individual resident shareholders. Also, as buybacks are conducted on the basis of registered rather than beneficial shareholdings, this will distort the overall picture of shareholding pattern.

Implication of the Capital/Dividend Split

5.29 What is the appropriate methodology or methodologies for determining the capital/dividend split?

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

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

Members advise that the Average Capital Per Share (ACPS) methodology is appropriate to most buyback circumstances. The 'slice approach' may also be appropriate in certain circumstances. As such, there would be value in specifying these methodologies in a safe harbour to eliminate the need to obtain a ruling from the ATO at every instance.

The provision of a safe harbour in the application of these two methodologies in the form of a public ruling that is binding on the ATO would deliver on this objective, as well as providing some flexibility to amendments to the safe harbour provisions if needed in the future.

The ATO's Practice Statement recognises that other methodologies may also be appropriate, and they should be dealt with through the current private/class rulings process. The existence of a safe harbour provision should not limit the ability of companies to seek the application of other methodologies where appropriate.

3. Simplicity

Reducing Compliance Costs

5.35 How could the compliance and administration costs of the provisions be reduced?

Whilst off-market share buybacks are an efficient mechanism for the return of capital relative to other options for capital return, these efficiencies can be enhanced further by the reduction of unnecessary compliance and administration

costs. As the law is currently administered, companies generally view the need to obtain rulings from the ATO as essential. The development of a safe harbour to specify commonly accepted administrative practice, preferably in the form of a public ruling, would significantly reduce the costs of compliance for companies and their shareholders.

5.36 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?

AFMA agrees with the aspects of a buyback that should be specified in a safe harbour, as submitted by UBS:

- Determination of the capital/dividend split using the ACPS methodology or slice approach;
- Determination of market value using the S&P/ASX 200 Index or an adjusting mechanism approved by the ATO in a prior buyback (subject to the continuation of s.159GZZZQ(2));
- Exclusion of shares acquired on or after the ex-entitlement date for the buy-back from the 'last-in, first-out' principle of the 45-day holding period rule;
- Ratification of off-market buyback timetables which have no more than seven clear business days between the announcement date and the record date;
- Relief from the requirement under subsection 202-75(2) of the ITAA 1997 which requires that a distribution statement be given on or before the day on which the distribution is made;
- Determination of any applicable franking debit for non-resident shareholders based on the formula outlined in the ATO's Practice Statement 2007/09; and
- Confirmation that ss.45A and 45B should have no application to off-market share buybacks.

4. Concluding Comments

In making its recommendations to the Government, the Board may find it helpful to refer to the policy context within which the tax and regulatory treatment of share buybacks is placed. The Government has sought through the Corporate Law Economic Reform Program (CLERP) to promote efficient capital markets that provide higher returns to investors and support economic growth; for example, by enhancing the market for corporate control. Against this backdrop, it is important to retain an efficient share buyback mechanism as a tool for companies to manage their capital structure.

There have been relevant reforms on the tax front too, which operate in parallel with the corporate law reform. The Government also introduced a new thin capitalisation tax regime in 2001, the effect of which is to require companies with international operations to hold a minimum level of capital for tax purposes. Since companies must now manage their capital base with an eye to their tax position, it seems only reasonable that the tax law operates in a manner that enables companies to efficiently manage their capital base by issuing new capital or returning capital to shareholders, as necessary.

We would like to commend the Board on the comprehensive analysis of off-market share buybacks presented in the discussion paper, which should contribute to well informed discussion on the proposals being considered. We look forward to the

Board's final report from this review, and should we be of further assistance, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink that reads "Duncan Fairweather". The signature is written in a cursive, slightly slanted style.

Duncan Fairweather
Executive Director