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Review of the Taxation Treatment of Off-Market Share Buybacks
The Board of Taxation
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To the Board of Tax,

The current tax treatment of off-market share buybacks is efficient, equitable and consistent with the Government's policy of a progressive income tax system. To deny companies the ability to distribute franking credits via off-market buybacks would effectively discriminate against those who derive their income from shares as opposed to other forms of income such as rent or wages. This type of change would also be detrimental to the business community, decreasing the value and flexibility of capital management of companies with excess franking credits. This would adversely affect all shareholders and the entire community.

I am confident that the Board of Tax and the Australian Government will continue to see and will want to maintain the economic benefits that off-market share buybacks provide. However, my main concern is that the Board may be influenced by arguments that the ability of shareholders to participate in any future off-market buyback should be restricted to those shareholders who own stock in a company before it announces a buyback.

As will be explained below, this change would have negative consequences for all shareholders, regardless of their marginal tax rates and whether or not they participate in buybacks. My concern is that denying franking credits to those who purchase shares in a company after it announces a buyback would not improve and may even worsen the situation of opponents to off-market buybacks who do not approve of the use of excess franking credits to fund a large component of the buy-back payment.

The argument of the critics of buy-backs essentially is that because of their high marginal tax rate they do not gain any tax advantage from receiving a fully franked dividend in a buy-back situation especially compared with being subject to 50% discounted capital gains tax liability when their shares are sold on market.

However this does not mean that off-market buy-backs do not advantage all shareholders. In essence, the current arrangements encourage new investors to purchase shares in the company to gain the tax advantages of the buy-back. This additional buying increases the share price allowing existing investors who do not benefit from the tax advantages of buy-backs to sell their shares on-market at a higher price than would otherwise be available.

The introduction of new shareholders to the register after the buy-back is announced has a further benefit to the company and all shareholders in increasing the competition to accept the buy-back at the highest possible 14% discount to the VWAP. In recent buy-backs, this has been clearly demonstrated by the large scale-backs of the number of shares accepted in the buy-back. If the opportunity to participate in the buy-back is restricted to existing shareholders, this would result in the final tender price being set at a smaller discount to the market price and/or a greater percentage of shares tendered being accepted in the buy-back.

This action would not improve the situation of existing higher marginal rate shareholders in the company but would greatly increase the benefits to existing large institutional low marginal rate taxpayers because of reduced competition to gain the benefits of the franking credits included in the buy-back payment. In this process, restricting access to the buy-back to existing shareholders would not provide an immediate beneficial impact on the share price.

Some critics of off-market buy-backs may perceive allowing new low marginal rate shareholders to participate in the buy-back to be unfair to investors on high marginal tax rates who would actually lose money if they participated in the buy-back. However, the reality is that if new shareholders were denied access to the benefits of the buy-back, existing low marginal rate shareholders would gain even greater benefits from the buy-backs. The more competitive the buy-back process is made, the greater the benefit to the company and high marginal rate shareholders.

The ironic reality is that to deny franking credits to new shareholders in some attempt to overcome a perceived inequity would actually punish those shareholders who would not have participated in the buy-back. That is, it would punish those on high marginal tax rates – the same class of investors opponents to buy-backs say they are trying to help. This is because such investors would no longer be able to realise an immediate increase in the value of their shares.

High marginal tax rate shareholders in a company that undertakes a buyback benefit immediately and over time. This is because the company in which they own shares has invested in its own shares at a cost lower than the market price. Shareholders also receive a far more tangible and immediate benefit via the company's share price appreciation as a result of a buy-back announcement increasing the demand for such shares by investors on low marginal tax rates. This increase in share price is immediately realisable by shareholders on high marginal tax rates should they decide to sell their holdings.

If access to franking credits were denied to shareholders who purchased shares after the announcement of a buyback, the immediate increase in demand for these shares would not eventuate. Shareholders on high marginal tax rates who would not participate in the buy-back could not sell their shares to those on low marginal tax rates at an increased price, since the demand would simply not be there. Therefore, shareholders on high marginal tax rates would not receive any direct or immediate benefit from the buy-back process if franking credits were denied to new shareholders or those on low marginal tax rates.

Therefore the consequence of denying investors who buy after the announcement of the buy-back the ability to participate in the buy-back and/or denying them the associated franking credits is that all investors are financially worse off. Those investors who held shares prior to the announcement of a buy-back would be denied an immediately realisable appreciation in the value of their holdings. Investors who would otherwise buy shares in a company after a buy-back announcement would have lost the incentive to do so. Worse still, the current fierce competition to compete in buy-backs would be reduced to the detriment of individual companies and the entire community. That outcome would not be efficient nor would it be fair to anyone.

I appreciate the opportunity to offer this submission and look forward to the Board's recommendations.

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