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Review of the Taxation Treatment of Off-Market Share Buybacks
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

24 August 2007

Dear Board of Taxation,

Re: Submission to the Review of the Taxation Treatment of Off-Market Share Buybacks

Thank you for the chance to comment on the Board of Taxation's inquiry into the taxation treatment of off-market share buybacks. My recent research activity into taxation law includes the tax treatment of off-market tender share buybacks, particularly in light of the Commissioner of Taxation's change in methodology and the reasons given for the change put forward in Tax Determination TD 2004/22.

This research includes an empirical study of the discounts on shares tendered for repurchase through an off-market share buyback, prepared in collaboration with Professor Adam Steen. This study compared the discounts under tender buybacks conducted prior to the release of TD 2004/22 with those after the release of TD 2004/22. The results of this study are inconsistent with shareholder behaviour that is motivated primarily by tax considerations. This finding may have implications for recommendations that the Board of Taxation could make leading to reform in this area.

Our expectations when embarking on this project were that we would find discounts on tender buybacks conducted prior to the release of TD 2004/22 would be deeper than those that came after the release. These expectations were based on the Commissioner's concerns expressed in TD 2004/22 that the deep discounting that had previously taken place was driven by tax considerations, implying that shareholders would tender at higher prices if the tax benefits associated with such transactions were reduced. The methodology put forward in TD 2004/22 has this effect, so we expected to find that discounts would have become lower in general after the application of TD 2004/22.

There are solid theoretical grounds for expecting shareholders to behave in this fashion. As the mathematical models presented in the Board of Taxation's consultation paper demonstrate, shareholders on the top marginal tax rate for

individuals (including Medicare levy) should not, rationally, participate in such buybacks (preferring to sell on the open market). In a similar vein, the lower the shareholder's marginal tax rate, the greater the overall benefits from participation, once tax effects are taken into account. This leads to an expectation that the tax benefits are valued in some way by shareholders, which is manifested in their preparedness to tender their shares at a discount to gain access to these valuable tax benefits (consistent with the assertions made by the Commissioner in TD 2004/22).

Based on these observations, we anticipated that any action that reduced the tax benefits associated with these buybacks (such as the new methodology in TD 2004/22) would result in shares being tendered at lower discounts. Contrary to these expectations, our testing found evidence of a deepening of discounts after the application of TD 2004/22.

Due to the limited data available (only five buybacks took place prior to TD 2004/22 and 19 after), it is difficult to draw definitive conclusions from this study. However, at a minimum, these findings do suggest that taxation is not the motivating factor in determining the level of discounting that takes place that had previously been anticipated. Stronger conclusions may be drawn once more data become available, particularly as more buybacks are conducted under differing market conditions (most of the post-TD 2004/22 buybacks took place in a rising market, leading us to speculate that prevailing market conditions could have dominated over the expected taxation effects).

Given that the evidence obtained from this study suggests that taxation considerations are not the significant driving force originally anticipated, it should not be immediately assumed that shareholders are tendering their shares at deep discounts only to obtain tax advantages. This undermines the logic presented in TD 2004/22 for the change in methodology. While it is acknowledged that the methodology is consistent with the provisions dealing with the taxation of off-market buybacks, such a stance should not be justified essentially on grounds of preventing tax avoidance.

Further, this evidence should be taken into consideration in the application of the integrity provisions (such as ss 45B and 177EA of the ITAA 1936) that are premised on the Commissioner's assessment of the conditions surrounding the transaction in issue. In particular, the evidence indicates that a tax avoidance motive should not be attributed automatically to an off-market buyback transaction, even in circumstances that would lead one to expect, in isolation, that tax avoidance did play a part.

While the study that provided the evidence referred to in this submission has not been submitted for publication as at the time of writing (although it is expected to be done so very soon), a draft is available on request.

Yours sincerely,

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