FINANCIAL REGULATION DISCUSSION PAPER SERIES

Off-Market Share Repurchases - Policies Wanted!

FRDP 2011 - 01

March 3, 2011

In this ACFS Discussion Paper, Professor Kevin Davis notes a resurgence of interest in (and controversy about) off-market share repurchases and asks what has happened to changes proposed in 2009 to the tax treatment of such transactions. Of two major proposed changes, one has significant merit and warrants introduction, while the merits and benefits of the other is less obvious.

Off-market share repurchases (buy-backs) have been a significant form of corporate capital management in Australia in recent years. Between 1996 and 2008 there were over 80 such buybacks which returned around $27 billion of cash to participating shareholders. While there was little activity during 2009 and 2010, there are expectations of considerable use of buybacks during 2011, with BHP having announced a $5 billion buyback in February, and Woolworths having completed a $700 million buyback in October 2010.

These transactions are not without their critics, with the main issue of contention being whether they involve equitable treatment of shareholders (and an associated question of whether they are consistent with legal requirements for such treatment). The reason for these concerns lies in the way such transactions are structured enabling substantial tax benefits to be passed to shareholders who participate in the buyback. While that appears to disadvantage non-participating shareholders, competition for these tax benefits leads to the buyback price determined in the tender process being below the current market share price, which is a benefit to non-participants.

In May 2009, a Board of Taxation study of off-market repurchases[1] was released by the then Assistant Treasurer, with an announcement that the Government planned to introduce legislation to implement the six recommendations of the study. Two of those recommendations were particularly significant, and would have substantially changed the way in which such transactions are conducted – and most likely have reduced their attractiveness to companies and shareholders as a way of distributing surplus cash and franking credits.

A Treasury discussion paper[2] outlining possible legislative changes was released on June 1, 2009, however, no legislative action has yet occurred on this front and buybacks are still operating under the old arrangements.

At least one of two major changes proposed then has merit, and should be implemented as soon as possible, while the other is more contentious.

Off-market buybacks are conducted as tender offers in which the payment made by the company comprises a small amount of capital repayment with the remainder taking the form of a franked dividend. Tax rulings mean that participants in the buyback thus get substantial tax benefits from a capital loss (their purchase price less the small capital repayment component) and from dividend franking credits attached to the dividend component.

Consequently, such buybacks occur at less than the current market price of the shares through competition in the tender for the associated tax benefits arising from selling into the tender. They are particularly attractive to shareholders on zero or low income tax rates (such as superannuation funds), and there is much attention paid to the prospect of such buybacks in the financial advice industry. For shareholders on high marginal tax rates, participation is not worthwhile. (While the capital loss for tax purposes is valuable, there is additional tax to be paid on franked dividends, which makes selling at a below-market price unattractive).

This tax-based discrimination against shareholders on high tax rates has led to concerns about equitable treatment of shareholders and the consistency of such buybacks with requirements that companies should treat all shareholders equally. In effect, the argument is that valuable franking credits are being syphoned to one group of shareholders to the detriment of others.

The shortcoming of this argument is that non-participating shareholders benefit from the below-market price at which shares are repurchased from participants. Thus, both participants and non-participants benefit at the expense of the taxpayer from the realisation, rather than deferral of tax benefits available to the company and its shareholders.

This prompts two questions, answers to both of which would have been affected by the lost tax changes. First, why is there this unusual tax treatment allowing participants substantial capital losses for tax purposes? Second, are the benefits equitably shared between participating and non-participating shareholders?

One of the proposed tax changes was to remove the ability of participating shareholders to claim a tax loss for tax purposes. That would have substantially reduced the appeal of off-market buybacks and led to much lower repurchase price discounts to market price for those which occurred.

Is that an appropriate change? Arguably not. The existing tax treatment can be thought of as equivalent to a partial wind-up of the company involving return of capital (which should not be taxed) and retained earnings (and associated franking credits). Even though the current shareholder may not have contributed capital, having bought shares on-market from previous holders at a higher price than the original issue price, those individuals would have paid capital gains tax on receipts - some part of which correspond to the return of capital in the buyback. But that interpretation is open to challenge and this question warrants greater analysis and discussion.

The second proposed change was to remove the 14 per cent maximum discount to current market price which the ATO effectively imposes on buyback prices. Almost all recent buybacks are constrained by that maximum discount, as is obvious by the substantial scaling back of applications.

Recent research[3] indicates that without the constraint the average discount would have been around 21 per cent. Non-participating shareholders would thus have been better off – because shares were bought back at lower prices.

The 14 per cent discount limit (seemingly plucked out of the air by the ATO) thus means that the distribution of the total tax benefits is biased towards participants in the buyback. Even though these are low tax rate investors, many of them are self managed superannuation funds of well endowed investors.

Removing the 14 per cent discount limit thus is an obvious policy change which should be resurrected from wherever it is languishing. The other proposal (to preclude capital loss tax claims) is in a different category, and warrants further debate. Of course, if it were to be implemented, the 14 per cent limit would, because of the reduced attractiveness of buybacks, most likely become irrelevant.

With the resuscitation of corporate interests in off-market buybacks, it is important to clarify the tax arrangements sooner rather than later, and resolve debates about equitable treatment of shareholders which will otherwise resurface.

This FRDP was prepared by Kevin Davis, Research Director, Australian Centre for Financial Studies and Professor of Finance, University of Melbourne.

[1] The Board of Taxation *The Tax Treatment of Off-Market Share Buybacks*, June 2008
http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/off_market_share_buybacks/default.htm&pageid=007
[2] The Treasury, *Discussion Paper: Improving the taxation treatment of off-market share buybacks*
http://www.treasury.gov.au/documents/1550/PDF/Discussion_Paper_off_market_share_buybacks.pdf
[3] Christine Brown and Kevin Davis *Tax Heterogeneity and Stock Supply Elasticity: Evidence from Australian Off-Market Repurchases*.