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Improving the integrity of off-market share buy-backs

The draft legislation to align the treatment of off-market buybacks with on-market buybacks is welcome, since it will prevent the inequitable treatment of shareholders, protect the integrity of the dividend imputation tax system, and reduce the inappropriate cost to government tax revenue caused by Tax-Driven Off-Market Buybacks (TOMBS). There is no reason for these highly structured financial transactions to exist, other than exploitation of the dividend imputation tax system to stream franking credits to low tax rate resident shareholders. Rather than combining franked dividend payments and return of capital in a TOMB, companies can distribute franking credits pro rata to shareholders via special dividends and return capital via on-market or "capital-only" off-market buybacks.

There has already been a significant amount of noise and posturing arising from vested interests opposing the proposed change. We believe that close examination of those statements will demonstrate the lack of any sound logical foundation, and that their basis is purely to preserve the benefits which some shareholders (and their advisers) obtain, at the expense of other shareholders and government revenue, from TOMBS. It is worth emphasising that the total number of such buybacks is relatively small, around sixty since the first one in 1997, and generally by very large companies, with some having done multiple such buybacks. Thus, TOMBS are not a common technique of capital management for the bulk of Australian companies, and prohibition would have little overall impact for the majority of companies. We strongly urge legislators not to succumb to the scare campaign which has already been mounted in opposition to the proposed legislation.

In our published academic research (Australian Tax Forum 2019 – a copy available here) we have identified the cost to government revenue of TOMBS, and identified the inequitable treatment of shareholders involved. In some of our public policy commentary we have identified the apparent regulatory capture involved in the allowance of TOMBS with their artificial structural characteristics. As we discuss below, the flexibility allowed to regulators in their oversight and approval of off-market buybacks is not considered in the draft legislation, but is an important consideration in the approach to good regulation of off-market buybacks.

In what follows we address the following issues. First, we discuss the proposal to prevent inclusion of a dividend component in off-market buybacks, which we strongly support. Second, we examine the implications for shareholders from the proposal.

Third, we consider the proposal that, as in the case of on-market buybacks, a debit will be made to the company's franking account balance (FAB). This is a complex topic which warrants detailed examination, beyond that possible here, to identify the appropriate size of debit to be applied. The legislation does not prescribe the actual size of the debit, which would be determined by regulators (presumably by the Australian Tax Office (ATO)). Since the actual debit determined by the regulators could be zero or some positive amount, the inclusion of this provision in the draft legislation (and also in legislation regarding on-market buybacks), is not a matter of legislative concern. However, there is a case for examining more closely how regulators should determine an appropriate debit. We have been unable to locate examples of debits to the FAB for on-market or off-market buybacks. Public information about those numbers would be good regulatory practice. In our published academic research (Australian Tax Forum, 2019) we demonstrate that the formula used by the ATO for debiting the franking account for the streaming of franking credits away from foreign shareholders is incorrect, which causes us to lose faith in how the debit is calculated more generally

Fourth, we consider the flexibility provided to ASIC in granting relief from provisions surrounding "equal access" off-market buybacks – which has been necessary for TOMBS to be allowable. Again, the draft legislation contains nothing about this topic, but it is an important issue in the regulatory implementation of the legislation.

Prevention of a dividend component in off-market buybacks

TOMBS have emerged primarily as a mechanism for the "streaming" of franked dividends to zero or low tax-rate shareholders. That is readily apparent from the statistics. There have been very, very, few cases of TOMBS involving an unfranked dividend (see Brown and Davis, *Accounting and Finance,* October 2012).

Internationally, buybacks have generally taken the form of a return of capital (either automatically in the case of on-market buybacks or specified as such in off-market buybacks) rather than having any dividend component. Where off market buybacks have occurred (generally referred to as self-tender offers in the

US) the unfavourable taxation of dividends relative to capital gains dictates a return of capital approach, with the buyback price exceeding the current market price to compensate participants for realisation of capital gains.

One attempt to justify TOMBs is to argue that they are akin to a hypothetical partial liquidation of the company involving a distribution of original capital and accumulated profits associated with the part of the company being liquidated. As we discuss in our Australian Tax Forum article, that interpretation creates implementation and administrative problems, as well as being a dubious analogy, making it a poor justification for a practice which is unnecessary. As stated earlier, companies can achieve the same distribution of cash and franking credits as a separate return of capital and a special franked dividend paid pro rata to all shareholders. The only difference is the pro rata nature of the distribution rather than the streaming of those amounts to successful participants in the tender process. The streaming of franking credits involved in TOMBS flies in the face of the tax code underlying the dividend imputation system and violates the principle of equal treatment of all shareholders by the company. As we have argued elsewhere, the compensation for this unequal treatment received by non-participating shareholders, in the form of repurchases occurring at a below market price does not achieve an equitable outcome.

Shareholder Consequences

Much of the opposition to the draft legislation will come from certain shareholder groups and their advisers. They apparently stand to lose the benefits received from successful participation in the tenders in the form of receipt of franked dividends. These groups are zero and low tax rate shareholders who place a higher value on franking credits than higher tax rate shareholders (and foreign shareholders who cannot, and would not want to, participate).

It is important to stress that the current "winners" from participation in TOMBs are benefitting at the expense of other shareholders. Some part of that wealth transfer arises from the ATO having placed a limit of 14 per cent on the maximum discount, where our calculations have indicated that a "free market" outcome would lead to discounts in excess of 20 per cent. Were TOMBs to remain permissible, but the ATO were to remove the maximum discount allowed, it is possible that the steep discount resulting from the tender process would tend to lead towards a natural death of the TOMBs market. The reason is that potential participants expecting such a large discount outcome would see no net benefit in participating to obtain franked dividends at the cost of the significantly lower than market price received for their shares. However, such a conclusion depends on the proportions of shareholders in different tax brackets and of domestic/foreign shareholders, which will influence the resulting discount.

It is also worth noting that the net gains received by participants in a TOMB are at least partly illusory. While they benefit from the shares they subscribe to the TOMB, they are generally also substantial holders of other shares in the company which are not accepted for participation, and on which they suffer a loss from the transfer of value to shares participating in the TOMB. While some very small shareholders may have all of their tendered shares accepted, the average "scaleback" (shares repurchased relative to shares offered at the final tender price) is in the order of 50-60 per cent.

Finally, it is important to note that there is much uncertainty regarding which specific shareholders will ultimately be participants in a TOMB. Long term shareholders in a company may find themselves partly squeezed out of successful participation by the inappropriate regulatory allowance of companies being able to announce a TOMB with more than forty-five clear days until the tender finalisation date. This allows "smart money" investors to purchase shares after the announcement date for submission in the tender and to still be able to use the franking credits received from success in the tender.

Franking Account Balance (FAB) Debits for On and Off market debits

The draft legislation aligns the treatment of off market buybacks with that of on market buybacks. One consequence of that is that the practice of a debit being made to the company's FAB when an on-market buyback occurs will now also apply if an off-market buyback occurs. The size of the debit (which could be zero) is not specified in the legislation (appropriately), but left to determination by the ATO. This will occur even though a dividend component is not allowable in an off-market buyback under the proposed legislation – with the entire payment being (as in the case of on market buybacks) a return of capital.

There is some economic logic and legal basis which can justify the practice of making some such debit. Preserving the integrity of the dividend imputation system by limiting the ability of companies to distribute funds as (concessionally taxed) capital when they are in reality profits on which shareholders would instead face income tax is important.

There is discussion provided by the ATO on how it calculates the "appropriate" debit, with relevant considerations including both accounting issues (such as the proportion of the buyback price being debited to the share capital account versus retained earnings) and the typical franking rate of the company. The issues are complex and warrant further examination and elaboration by the regulators to provide clear justification for the debits applied.

As noted earlier, we have argued that the debit formula used in TOMBS appears incorrect, which raises the issue of the appropriate formula to be used more generally. We also note that the appropriate debit would seem likely to depend on the empirical question of whether (or how much) unused franking credits are valued in the determination of the current share market price. If not valued, the market price of shares in a company with unused credits will be lower than if the credits were reflected in the market price.

Regulatory Flexibility and Regulatory Arbitrage

The financial engineering involved in TOMBS has meant that companies wishing to undertake such a transaction need to obtain a number of regulatory approvals from the ATO and ASIC. We have outlined those and suggested that "regulatory capture" has occurred , in our public policy article.

Preventing TOMBs removes some of the scope for this to occur. However, it should be noted that there will remain some regulatory judgement required if any companies wish to undertake a "capital-only" off market buyback. This includes the ability of ASIC to grant relief from the equal-access provisions generally required if the company is to undertake an off market buyback by means of a tender (rather than pro rata participation) This is not a concern for the legislation, but is something which the regulators charged with implementing the legislation should consider.

Conclusion

We strongly support the draft legislation and urge the government to stand firm against the likely attacks on the proposed changes. While the changes are partly driven by the potential impact that TOMBS can have on government revenue, we argue that equity and fairness are equally important considerations. The net benefits received by some shareholder groups need to be set against the net costs to other shareholders (shareholdings) which do not participate.

We also note our opposition to the other piece of current draft legislation (Franked Distributions and Capital Raisings) which has been outlined in our submission to that Consultation. Not only is that proposed legislation misguided, the passage of this draft legislation (Improving the Integrity of Off-Market Buybacks) would largely remove the practices which prompted that misguided legislation.

Should you have any questions or require further information, please feel free to contact us

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