Tax-driven Off-Market Buybacks (TOMBs): Time to Lay Them to Rest

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Abstract

Tax-driven Off-Market Buybacks (TOMBs) have been used by large Australian companies to distribute cash and stream franking (tax) credits to low-tax-rate shareholders. While small in number, the amounts are significant, involving an estimated cost to 2018 government tax revenue of around $2 billion. This paper reviews the current and historical evolution of the regulation and taxation of TOMBs and argues that there are fundamental problems with corporate use of TOMBs. These include inequitable treatment of shareholders, government tax revenue costs, inconsistency with good principles of taxation, arbitrary tax determinations and practices which are difficult to justify. Since corporates can distribute cash to shareholders using other, quite standard, capital management techniques, we argue that a social cost-benefit analysis leads to the conclusion that TOMBs should be prohibited.

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Introduction

In December 1995, the legislation governing share buybacks (or repurchases) by Australian companies was substantially liberalized, simplifying the procedures involved. Since that time, there have been a large number of buybacks.[1] For taxation purposes there are two types of buybacks. Buybacks that occur through the company repurchasing shares in the ordinary course of trading on the exchange are termed 'on-market'. All buybacks that do not occur on-market are defined as 'off-market' buybacks. Both types of buybacks are subject to regulation.[2] Our focus in this paper is a particular type of off-market buyback, which we describe as Tax-driven (equal-access) Off-Market Buybacks, and label as TOMBs. They involve an invitation to shareholders to offer shares for repurchase by the company for a payment which is treated for tax purposes as comprising a franked dividend amount and a capital component (sale price) amount.

While relatively small in number and primarily used by very large companies, over the past two decades the dollar amount involved is comparable to the much larger number of on-market buybacks. Our analysis of the social costs and benefits of TOMBs leads us to the conclusion that these complicated structured transactions should be banned. The principal arguments are that: (1) TOMBs are unnecessarily complex in structure and involve complicated tax treatment inconsistent with good tax policy. (2) They require special ASIC regulatory determinations (granting of relief) since TOMBs do not fit into any of the legislated types of allowable buybacks. (3) They are (under current regulatory arrangements) unfair to non-participating shareholders (4) TOMBs are a significant cost to government tax revenue through a "streaming" of franking credits to zero/low resident taxpayers, and (5) Other capital management tools can achieve similar outcomes for companies which do not involve "streaming" of tax credits. We also question the transparency and consistency of tax rulings involved in individual TOMBS transactions. We conclude that it is past time for TOMBS to be laid to rest (with an appropriate tombstone engraved with "here lies another undesirable tax distortion").

The structure of the paper is as follows. First, we outline the current structure, taxation and regulatory treatment of TOMBs and consequences for participating and non-participating shareholders. In Section 2, we provide the historical development of regulatory and tax changes to illustrate how legislators and regulators have struggled in attempting to achieve a socially optimal treatment of TOMBs. Section 3 provides an overview of a recent (2018) large TOMB by BHP to illustrate these issues in more detail. Section 4 provides a brief overview of the size and growth of the TOMBs market and the adverse consequences for government tax revenue which result. Given the complex structure of TOMBs, we provide an analysis in Section 5 to show how the designation of TOMBs buyback price as part return of capital and part dividend could be rationalised, and complications arising in doing so. In Section 6 we compare TOMBs with other capital management actions available to firms which have the same outcomes for the company. Because there is no "streaming" of franking credits to low tax rate shareholders, these alternatives involve lower cost to government tax revenue and avoid the unfair treatment of some shareholders arising from TOMBs. This facilitates an answer to the question of

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[1] We use the terms buyback and repurchase interchangeably. In the U.S., on-market buybacks are termed open market repurchases, while off-market buybacks are called self-tender offers.

[2] See Appendix 1 for definitions and an overview of these regulations.

whether the evolution of legislation and tax arrangements made sense, and whether changes to allowable structures and tax treatment are warranted. Our concluding Section 7 summarises and includes our policy recommendation to make changes, which would sound the death-knell for TOMBs.

1. TOMBs – structure and current tax treatment and regulation

Legislation (*Corporations Act 2001, Cth*) provides for four types of off-market buybacks: selective, minimum holding, employee share scheme related, and equal access. See Appendix 1 for definitions and relevant regulations. TOMBs do not meet the required criteria for automatic designation of any of these types, but ASIC grants relief for their designation as "equal access". In principle, an equal-access off-market share buyback occurs when companies invite all shareholders to tender shares *pro rata* back to the company. Although named "equal-access", only "eligible" shareholders may participate. Foreign shareholders from certain jurisdictions (usually including shareholders in the U.S. and Canada) are deemed 'ineligible' to participate, because an offer to shareholders in those jurisdictions would breach securities laws in those countries.[3] Relief is given by ASIC to allow the company to use a Dutch auction to determine participants and to differentially scale-back acceptance of amounts offered by different shareholders in the event of over-subscription.[4]

Companies typically structure a TOMB so that the buyback price (often determined via a tender process)[5] consists of a franked dividend component and a capital component. The announced capital component of the final buyback price is often quite small. The franked dividend component, calculated as the buyback price minus the capital component, is consequently quite large (on average around 70 per cent of the total). The dividend, drawn from the distributable profits of the company, and treated as income for the selling shareholder, delivers imputation tax credits to participants. The capital component is debited against the company's share capital account and, depending on the selling shareholder's cost base, may generate capital losses for tax purposes for participants.

The capital gains tax calculation for participants is complex. The announced capital component is "scaled up" as follows. A "Tax Value" is calculated as the announcement date share price[6] adjusted by the movement in the ASX index (or other agreed indicator) between the announcement and closing dates. If the buyback price is below this "Tax Value", the difference is added to the capital component to get the designated sale price for capital gains tax calculations.[7]

[3] The company's board may determine that the cost of compliance with securities laws in other jurisdictions is unreasonable. Ineligible shareholders must be notified of the offer and informed of their ineligibility. For example, in the case of the Perpetual Limited buyback in 2011, in CR 2011/102 at paragraph 14, the ruling stated that the offer was open to all shareholders "except for US and Canadian resident shareholders because the resultant applicability of US and Canadian tender offer rules would reduce flexibility of Perpetual in conducting the Off-Market Buy-Back."

[4] ASIC grants an exemption under s257D(4) of the Corporations Act to treat the off-market buyback as an equal-access buyback. See https://download.asic.gov.au/media/1240127/rg110-updated-published-7-august-2017.pdf

[5] Prior to mid-2002, all TOMBs specified a fixed buyback price. From June 2002, all TOMBs have used a Dutch auction process to determine the price and successful participants.

[6] This is calculated as the VWAP (Value Weighted Average Price) of the company share price five days leading up to and including the announcement.

[7] Division 16K of Part III of the ITAA 1936 was enacted in 1990 to deal with the tax treatment of share buybacks. After mid-2002 when a Dutch auction process was used in TOMBs to determine the buyback price,

The incorporation of a large franked dividend component, can deliver considerable tax benefits to resident shareholders on low marginal tax rates who participate. This group includes charities, endowments, self-managed super funds, and institutional super funds, who face tax rates of either 0% or 15%. Compared to holding or selling their shares on the ASX, these tax benefits mean they are willing to sell shares back to the company at a price below the current market price. The ATO puts a ceiling of 14% on the discount of the buyback price to the prevailing market price,[8] with the level of discount a consideration in the Commissioner's application of the anti-avoidance provisions.[9] Because many shareholders are willing to sell shares at a larger discount, most buybacks are done at a price near the 14% limit and there is substantial scaling back of offers to sell at that price which are accepted.

This outcome of an offer price at a discount to the market price of the shares stands in stark contrast to the situation in other jurisdictions where the full proceeds of off-market buybacks are treated as capital proceeds. There the buyback price is typically at a premium to market price, because participation triggers a capital gains tax event for selling shareholders which would not have occurred otherwise.

The capital/dividend split of the buyback price of TOMBs (which must be approved by the Commissioner of Taxation), influences the tax benefits for participants, and drives much of the complexity in the tax treatment of such off-markets buybacks. Because TOMBs essentially stream franking credits to low-marginal-tax-rate resident shareholders, specific anti-avoidance provisions in the *Income Tax Assessment Act 1997 (Cth)* are applied to both the dividend and capital components of the buyback price. Since they were first permitted, a number of changes to the tax treatment of TOMBs have occurred, in addition to proposed changes, which were included in draft legislation but subsequently not enacted. These, and their rationale, are discussed in Section 2 below.

2. The evolution of regulation and tax treatment of TOMBs

As described in the previous section, the current legislative framework, together with the Australian dividend imputation system, affords companies the opportunity to structure the offer price in TOMBs so that participation can be tax advantageous to certain groups of shareholders. The tax treatment and the regulations governing TOMBs have evolved since Commonwealth Bank completed the first TOMB in 1997.

Table 1 provides the timing of significant regulations, tax rulings and practices. The operation of off-market share buybacks is determined by corporations law, Australian Securities

the ATO reviewed the mechanism for determining the market value of the shares at the time of the buyback 'if the buyback did not occur and was never proposed to occur'. TD 2004/22 gives details of the approach used to calculate the market value for off-market buybacks occurring at a price below the market price (see https://www.ato.gov.au/law/view/document?docid=TXD/TD200422/NAT/ATO/00001).

[8] This is calculated as the VWAP of the company share price up to and including the closing date.

[9] The most important elements of the anti-avoidance provisions are the qualified person rule (former Part IIIAA of the ITAA 1936 and TD2007/11); the anti-dividend streaming rule (s 204-30 ITAA 1997); the capital benefit streaming and substitution rules (s 45A and 45B ITAA 1936); general anti-avoidance provision for franking credit trading (s177EA ITAA 1936).

Exchange (ASX) requirements, exemptions granted by the Australian Securities and Investment Commission (ASIC), and taxation law together with Australian Tax Office (ATO) administrative practice. The legal requirements for buybacks are contained in the Corporations Act, which allows companies to repurchase shares as long as the buyback is fair and reasonable to shareholders as a whole and does not materially prejudice its ability to pay creditors. In general, companies are allowed (without requiring shareholder approval) to repurchase up to 10 percent of their ordinary shares in any 12-month period (commonly referred to as the 10/12 limit) and laid down in s257B(4) and s257B(5) of the Act.

Table 1: Evolution of regulation and tax treatment of TOMBs

Date	Type	Description	Relevant Legislation / Regulation
1990	Tax code	Amendments enacted in 1990 to deal with the tax treatment of share buybacks	Division 16K of Part III of the ITAA 1936
1995	Relaxation of regulations	Reduce the complexity of the rules and ease the regulatory burden on companies undertaking buybacks	First Corporate Law Simplification Act
16 July 1999	Introduction of 45-Day Rule	Royal assent to inclusion of 45-day rule in ITAA 1936, applied to all shares acquired after 1 July 1997	Section 160APHO(2)(a) of the ITAA 1936[10]
1 July 2000	Franking Credit Rebates allowed	Taxpayers with unused tax credits receive a rebate from the ATO	Division 67, ITAA 1997
2004	Market Uplift Rule	Change in calculation of sale price for capital gains tax purposes	TD 2004/22
September 2007	Maximum discount rule	ATO release of practice statement formally applying maximum 14 per cent discount of buyback price to current market price	PSLA 2007/9[11]
October 2011	Draft legislation (not enacted)	Would have abolished ability to claim capital losses due to low capital component	See Board of Tax (2007, 2008)[12]
December 2013	Announcement not to proceed with draft legislation	Media Release (A. Sinodinos)	

[10] https://www.ato.gov.au/law/view/document?LocID=%22RPC%2F19360027%2F160APHO(1)%22
[11] https://www.ato.gov.au/law/view/document?Docid=PSR/PS20079/NAT/ATO/00001&PiT=99991231235958
[12] The Board of Taxation, 2007, Review of the Taxation Treatment of Off-market Share Buybacks, Discussion Paper : http://taxboard.gov.au/consultation/taxation-treatment-of-off-market-share-buybacks/
The Board of Taxation, 2008, Review of the Taxation Treatment of Off-market Share Buybacks http://taxboard.gov.au/files/2015/07/off_market_share_buyback_report.pdf

Significant changes documented in Table 1 that affect the outcomes for a participant in a TOMB are as follows. The 45-day rule, applied after 1 July 1997, implies that franking credits attaching to the dividend component of the TOMB can be used only by 'qualifying' participants, who have held the shares 'at risk' for a minimum of 45 days (not including purchase and sale dates). Importantly the rule operates on a last-in first-out (LIFO) basis, which deems shareholders to have disposed of their most recently acquired shares first, in calculating eligibility for the franking credits attaching to the dividend component. Historically shareholders did not receive refunds for franking credits in excess of tax payable. However, on 1 July 2000, the Howard Government changed the tax treatment to pay out (previously unused) franking credits in cash to shareholders whose tax liability had been reduced to zero.[13] This change resulted in TOMBs being even more attractive to zero tax rate charities and super funds in retirement mode.[14]

From 2004, for tax purposes, the capital component designated by the company[15] in the offer document is subject to a 'market uplift rule'.[16] A capital component that is too high or too low may result in the streaming of benefits under various anti-avoidance provisions in ITAA1936 and ITAA1997.[17] Changes to the tax treatment introduced in TD2004/22 reflect the view of the ATO that the market value of the repurchased shares is an extremely important and practical issue for TOMBs occurring at a discount to market price. Empirical evidence[18] of positive abnormal announcement returns supports the idea that the announcement of the off-market buyback is likely to affect the market price of the shares. Prior to the enactment of TD2004/22, the capital component (approved by the Commissioner and recorded in the offer document) was the deemed selling price for capital gains tax purposes.

In October 2006, the Federal Government asked the Australian Board of Taxation to review the taxation treatment of off-market buybacks. The Board of Taxation (2008) Report to the government made several recommendations.[19] The first recommendation was to remove the 14 percent cap on the allowable discount to market price applied by the Australian Tax Office. Empirical evidence of buyback price outcomes for TOMBs supports this recommendation. Brown and Davis find that the cap imposed on the discount is to the detriment of non-

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[13] Australia is the only OECD country with a fully refundable dividend imputation system.

[14] Treasury estimates show that the overall value of dividend imputation credits refunded has increased from $1.9 billion in 2005-06 to $5.9 billion in 2014-15. The following document has been released by the Treasury under FOI. https://static.treasury.gov.au/uploads/sites/1/2018/07/FOI_2292_-_documents_final_redacted.pdf

[15] Several different methods are outlined in PS LA 2007/9, as ways in which the capital/dividend split can be calculated. PS LA 2007/9 states that the maximum discount allowed in an off-market repurchase is 14% calculated by reference to the volume weighted average price on the five days leading up to and including the closing date of the repurchase. In practice, the ATO had been applying this maximum discount in private rulings for some years prior to its official announcement. See https://www.ato.gov.au/law/view/document?docid=PSR/PS20079/NAT/ATO/00001

[16] TD 2004/22 https://www.ato.gov.au/law/view/document?docid=TXD/TD200422/NAT/ATO/00001. ITAA requires that the amount of consideration that a seller is taken to have received is the amount that would have been the market value at the time of the buy-back completion if the buy-back did not occur and was never proposed to occur.

[17] Specific anti-avoidance provisions in the ITAA affect the tax treatment of both the dividend and the capital components of the consideration paid to shareholders via the repurchase. See n9.

[18] See: Brown C.A. The Announcement Effects of Off-Market Share Repurchases in Australia, Australian Journal of Management 32, No 2: pp. 369-385 (2007); Au Yong, H., Brown, C. and C. Ho. Off-Market Buybacks in Australia: Evidence of Abnormal Trading around Key Dates, International Review of Finance 14, 551-585 (2014).

[19] We refer only to recommendations for listed companies.

participating shareholders.[20] The second recommendation was that there should 'continue' to be a debit to the FAB of the repurchasing company to reflect the fact that non-participation of foreign shareholders avoids a wastage (non-usage) of franking credits, and that there should be an explicit formula in a specific provision to bring this to effect. The third recommendation was to deny notional capital losses for tax purposes to all shareholders participating in TOMBs. The fourth recommendation concerned greater clarity around the method used to determine the dividend/capital split, the appropriate buyback timetable and the application of the 45-day holding rule. As the last two entries in Table 1 document, legislation reflecting these recommendations was drafted in October 2011, but never enacted.

It is clear that TOMBs are a tax-driven capital management tool. The evolution of the tax treatment of TOMBs reflects the difficulty in producing a logically consistent, fair and simple method to first define the capital component of the buyback price for tax purposes, and then effectively deal with the streaming of imputation tax credits attaching to the dividend component of the buyback price to low marginal tax rate resident shareholders. The next section provides an overview of a large recent (2018) buyback by BHP, in order to provide a concrete illustration of the structure of TOMBS and the tax consequences for potential participants. It includes an analysis of the implications of the 2011 proposed (but ultimately rejected) changes to the tax treatment by The Board of Taxation.

3. The BHP 2018 TOMB

An outline of the BHP 2018 TOMB will help clarify the procedures involved and the current tax treatment of the proceeds received by shareholders – and consequent incentive of different investors on different marginal tax rates to participate.

Procedures

On 1st November 2018, when its shares closed at $33.11, BHP announced its plan to return $7.3 billion to shareholders through an off-market buyback.[21] The off-market tender process commenced on 19th November and closed on 14th December 2018.[22] BHP stated its intention of repurchasing shares at a discount of up to 14 percent to the closing date market price (calculated as the 5 day VWAP of BHP Limited Shares). It invited eligible shareholders to tender some or all their shares at discounts to the market price of between 10 percent and 14 percent inclusive (at 1 percent intervals).[23] It also announced that for Australian tax purposes, the buyback price received by participating shareholders would comprise a capital component of $0.38 per share and a fully franked deemed dividend equal to the buyback price less $0.38 per share. For the purpose of capital gains tax calculations, the capital proceeds would be the $0.38 per share capital component plus an amount equal to the excess of the Tax Value over the buyback price.

[20] Brown C.A. and K. Davis, Taxes, tenders and the design of Australian off-market share repurchases, Accounting and Finance 52, 109-135 (2012).

[21] It announced a separate special dividend simultaneously, with dollar amount to be determined after the cost of the buyback was known. The buyback and special dividend were to be funded from the sale of US onshore assets.

[22] There are 43 clear days between announcement and close; however, the ATO in CR (2019/5) states that shares sold into the buyback and acquired on or before the announcement date of 1st November (and all other conditions for qualifying are satisfied) qualify for the franking credits.

[23] Retail shareholders could elect to submit offers to participate at the final price determined by the tender.

On 17th December 2018, BHP announced successful completion of the buyback, with a 58.7 percent scale-back.[24] It bought back approximately 265.8m shares (8.3 percent of issued capital), distributing $7.8 billion to participating shareholders. The final buyback price was set at $27.64 (a 14 percent discount to the closing date market price of $32.1387).[25] The capital component in the offer document was $0.38, so the fully franked dividend component was $27.26. Capital proceeds for tax purposes, however, were $4.92, being $0.38 plus the excess of the deemed Tax Value ($32.18) over the buyback price of $27.64.

In calculating the Tax Value, BHP sought and obtained approval from the ATO to use the change in the price of BHP Billiton PLC on the London Stock Exchange as the appropriate benchmark (see TD2004/22). This calculation resulted in the Tax Value of $32.18.[26]

Tax treatment

In this subsection, we examine how the tax treatment influences decisions to participate or not by different types of shareholders. A shareholder selling BHP shares into the off-market buyback, receives a cash price of $27.64. For taxation purposes, the shareholder declares a fully franked dividend of $27.26 in taxable income and capital proceeds of $4.92. We use the current tax treatment to calculate the after-tax position of the participating shareholder. For later reference we also illustrate the consequences which would have flowed from proposed, but rejected, changes incorporated into draft legislation as recommended by the Australian Board of Taxation (2008).

Suppose for the purposes of illustrating the tax outcomes for participating shareholders, that a shareholder bought the BHP shares on 19th May 2016 for $19.00.[27] Table 2 shows the after-tax position for superannuation funds on a marginal tax rate of 15 percent and tax-free charities (or super funds in pension mode), using both the current and (in italics, and shaded) 2011 proposed tax treatment of off-market buybacks. The after-tax outcomes under the current tax arrangements show that participating in the buyback is preferred to selling shares on-market for such low tax rate shareholders. (Similar calculations show that a higher marginal tax rate individual would be better off selling shares on the market). Note that we are assuming that the selling shareholder has realised capital gains from other investments against which to offset the capital losses.[28]

[24] Thus (except for shareholders submitting offers to sell quite small amounts) any shareholder offering to sell shares at a price at or below the final buyback price had only 41.3 per cent of that offer taken up.

[25] This is the VWAP of BHP shares on the ASX over 5 trading days up to and including 14th December, the closing date of the tender.

[26] While there appears to be no publicly available explanation of why this approach was approved, the choice appears to be consistent with the ATO approach of determining the market value on the premise that the buyback was never announced and never took place. That is, the approach abstracts from the announcement effect of the buyback on the company share price.

[27] This is the cost base for capital gains tax calculations, and the results of the comparisons in Table 2 are not affected by the particular value chosen under the current tax treatment. However, had the 2011 proposed changes been adopted, the choice would be relevant if capital losses would have eventuated.

[28] If not, the shareholder would carry forward the capital losses until used (slightly reducing the present value of the transaction).

Table 2: Buyback participation versus on-market sale

	Superannuation Fund (income tax rate = 0.15, 2/3 of capital gains included in taxable income)			Charity or superfund in pension mode (zero tax rate)		
	On-market sale	Participate in buyback (current rules)	*Participate in buyback (2011 proposed)*	On-market sale	Participate in buyback (current rules)	*Participate in buyback (2011 proposed)*
Sale price	32.14	27.64	*27.64*	32.14	27.64	*27.64*
Purchase price	19.00	19.00	*19.00*	19.00	19.00	*19.00*
Deemed sale price (Tax Value)		4.92	*4.92*		4.92	*4.92*
Capital gain	13.14	-14.08	*-14.08*	13.14	-14.08	*-14.08*
Tax on gain	1.314	-1.408	*0*	0	0	*0*
Defined dividend		27.26	*27.26*		27.26	*27.26*
Tax redeemable on dividend		-5.84	*-5.84*		-11.68	*-11.68*
Net after tax cash flow	30.826	34.99	*33.48*	32.14	39.32	*39.32*

It is important to note that the substantial scale-back of offers to sell, arising from the 14 per cent cap on the discount, affects the distribution of the benefits among shareholders. Any participating shareholder (except those with small parcels which are accepted in full) will have some shares which are repurchased and some which are not repurchased.[29] Shares sold into the buyback take place at a higher price than if there was no cap on the discount – to the benefit of the selling shareholder. But the resulting lower uplift in the market price of non-participating shares (since the company outlays more cash on the repurchases than would have been needed in the absence of the cap) is to the detriment of the non-participating shares of the shareholder.

This has three implications which we consider later. One is the effect on the incentive to purchase a package of shares after the announcement of the buyback in order to participate. Investors will be aware, from observation of prior TOMBs, that only a portion of that package will be accepted. The second is the consequences for the distribution of benefits from the TOMB to shareholders in different tax brackets. The benefits from selling a share into the TOMB overstate the benefit to participating investors. The reason is that the scale-back means that they are simultaneously non-participants with regard to the rest of their non-accepted shares. Third, the same issue is relevant in comparing a TOMB with a special franked dividend as another way of the company distributing franking credits – where all shareholders participate *pari passu*. The discount cap, by reducing the market price uplift, reduces benefits from the TOMB to non-participants – such as foreign shareholders. They may still, however, be in a preferred position relative to a special dividend where they would have suffered a share price decline reflecting payment of a dividend involving franking credits which are of no value to them.

[29] We are grateful to Andrew Sisson for bringing this, and its implications, to our attention.

The 2011 proposed denial of capital losses, at first glance, appeared as if it would have a large effect on the participation decision. However as the calculations in Table 2 show, for superannuation funds with a marginal tax rate of 15%, and who appear to have been the marginal investors whose bids determine the ultimate discount,[30] the net cost of the change is only 10 or 15% of the change in the deemed sale price. Under the current tax arrangements, for the example of Table 2 a superannuation fund has net after-tax 'cash flow' of $34.99, assuming the capital losses can be offset against capital gains on other investments. Under the proposed 2011 changes, the after-tax position would have been $33.48. For tax-free investors (such as charities and superannuation funds in retirement mode), the changes would not have altered the net tax benefits because they do not pay capital gains tax.[31] In fact, the Board of Taxation Report noted "that denying notional losses to participating shareholders will not undermine the viability of off-market share buybacks."[32]

4. TOMBs: Usage and Characteristics

There have been 57 TOMBs over the period from 1997 to 2018. While this number represents only around 16 percent of all off-market buybacks over the same period, TOMBs delivered over 97 percent of the funds returned to shareholders through off-market buybacks. In comparison, other types of off-market repurchases, such as selective, employee share scheme buybacks, buybacks to effect restructuring, buybacks as part of a plan to delist, do not generate the same tax benefits to participants and are economically small in comparison.

Table 3 shows the number of TOMBs each year from 1997 to 2018. In total, $45.8 billion of cash had been distributed to participating shareholders, along with around $16 billion in imputation tax credits.

There is considerable variability in the frequency of TOMBs year-on-year, with a marked fall-off in activity post 2007 until (with the exception of the $6 billion BHP TOMB in 2011) a resurgence in 2018. In addition to the BHP buyback outlined in the previous section, others in 2018 were Rio Tinto and Metcash. As at 21/5/2019 a further 2 TOMBs had been announced for an anticipated amount of around $2 billion. The possible election in May 2019 of a Labor government (which did not eventuate) with a policy program involving removing franking credit rebates led to media speculation of a possible surge in TOMBs usage by companies to distribute available franking credits before such a change occurred.

[30] Brown and Davis show that the marginal, price setting, participant in the buyback will be low (15%) tax rate investors such as super funds who have short term capital gains to offset. See n. 20.
[31] Their participation in TOMBs is driven by the large component of the buyback price designated as a franked dividend. The franking credits received enable them to receive a cash payment from the tax office equal to the amount of those franking credits.
[32] See Board of Tax Report (2008)(n12, page 2).

Table 3: TOMBs market history

Year	Number of TOMBs	Franking credits distributed ($m)	Amount Spent $m)
1997	1	$164.56	$650.63
1998	0	$0.00	$0.00
1999	4	$183.79	$692.25
2000	2	$593.13	$2,246.89
2001	6	$459.96	$2,031.63
2002	3	$97.71	$562.67
2003	4	$636.12	$2,394.78
2004	6	$1,430.85	$4,536.07
2005	6	$1,043.46	$3,121.96
2006	2	$1,131.50	$3,087.03
2007	6	$1,731.77	$4,605.75
2008	2	$129.09	$413.16
2009	0	$0.00	$0.00
2010	1	$265.56	$704.30
2011	3	$2,642.53	$6,244.20
2012	0	$0.00	$0.00
2013	0	$0.00	$0.00
2014	2	$212.37	$1,021.12
2015	1	$276.50	$560.27
2016	4	$481.20	$1,837.99
2017	1	$273.74	$749.91
2018	3	$4,216.89	$10,372.35
Total	57	$15,970.74	$45,832.99

Key Features of the TOMBs market

In order to summarise the key features of the TOMBs market we eliminate five small buybacks[33] leaving 52 TOMBs in the sample for analysis. Table 4 presents some summary statistics for this sample.

While the median franked dividend/offer price ratio is 65 per cent for all buybacks since 1997, that average hides an upward shift in the ratio after 2007. Since that time, the median has been 82 percent with only 5 of 15 buybacks having a ratio less than 60 per cent. In only two of those 15 buybacks has the 14 per cent maximum discount rule not been binding such that no scale-back was applied.[34] For the full sample, 35 TOMBs have positive scale-back with an average around 63 percent.

[33]We include only companies which distributed over $1 million in franking credits. There were four small buybacks: Gowing Brothers (1999), ThinkSmart Ltd (2014) and Excelsior Capital (2016 & 2018) that did not meet this hurdle. We also delete from the sample Lemarne Corp (LMC), a small buyback distributing only $1.6m in franking credits, and which is atypical given the 157 days between announcement date and the close of the tender.

[34] The Perpetual Limited buyback in 2011 is an interesting case. The company offered a tender discount from 6% to 10% in 1% intervals. It is not clear why the company did not offer shareholders to tender at the maximum discount allowed by the ATO of 14%. Since the release of TD 2004/22, Perpetual has been the only buyback where the maximum tender discount (as a percentage) specified in the offer booklet was not 14%.

Table 4: Key Features of TOMBs

Variable	Mean	Standard Deviation.	10th percentile	Median	90th percentile *
Shares bought /Shares sought (%)	105.31	25.65	70.56	100.02	139.50
Shares bought/Shares outstanding (%)	5.30	3.35	1.98	4.06	9.91
Discount (to market price 10 days prior to announcement) (%)	7.45	8.51	-2.36	8.80	17.29
Discount (to announcement date price) (%)	9.25	7.22	-1.15	9.70	19.29
Franked dividend/ Offer price (%)	69.29	18.95	41.64	65.00	94.64
Clear days between announcement and closing date	47.42	7.67	39	46	56
Scale-back (1 – shares bought/shares offered) as percentage	41.70	34.78	0	57.5	86.2
Scale-back (for those TOMBs with positive scale-back)	63.1	21.35	39	65.6	88.2
* The figures for discounts, which use prices at specific dates, exceed 14 per cent which is the maximum discount to the 5 day VWAP prior to the closing of the TOMB (and which also only came into operation in 2004).					

This has significant implications regarding the "fairness" of TOMBs. Participating shareholders would have participated at significantly higher discounts (lower buyback prices) which would be of benefit to holders of non-participating shares. Brown and Davis (2012) estimate that the equilibrium discounts would have been in the order of 20% plus for the TOMBs in their sample. By restricting the maximum allowable discount to 14% the ATO is thus favouring participants (already benefiting from concessional low or zero tax rates) at the expense of non-participants. The smaller uplift in the market price of the company's shares caused by the discount cap, is clearly disadvantageous to non-participants. The consequences for successful participants are *a priori* difficult to determine, since in the absence of the cap, some would have had their entire offer accepted at a lower price, while others would have no longer been successful bidders at that lower equilibrium price.

Were there no limit on the maximum discount, lower buyback prices would also, *ceteris paribus*, reduce the dollar value of franked dividends per share which would be distributed – since that value is calculated as the difference between the buyback price and the specified capital component. Thus to distribute a given amount of cash (and franking credits) the number of shares repurchased would need to increase.

Important dates, practices and regulations

Principal dates for companies undertaking TOMBs are the announcement date, the ex-entitlement (to participate) date and the date the tender closes. For sample companies the earliest ex-entitlement date is 2 days after the announcement. The ex-entitlement date occurs on average around 8 days after the announcement. For shareholders who have held shares for some time, and plan to sell into the buyback, the ex-entitlement date is immaterial. The ex-entitlement date might appear to matter for investors intending to buy the shares and tender them into the buyback. However, because the buyback price is below the market price, an investor will not adopt this strategy unless she can claim the franking credits.

Therefore, the important date is the date by which investors must purchase the shares in order to satisfy the 45-day rule for usability of franking credits, when they sell the shares to the company on the closing date of the tender.[35] From 2002 onwards, all TOMBs have at least 43 clear days between announcement of the TOMB and the closing date. Soon after the closing date of the buyback the company announces the outcome from the buyback together with any scaleback, as was illustrated in the BHP example in Section 3.

As documented in Table 1, the 45-day rule has applied to all shares acquired after 1 July 1997. The apparently evolving practice of the company setting more than 45 days between the announcement of the TOMB and the closing date of the tender, allows investors to purchase shares on or after the announcement date in order to sell those purchased shares into the buyback. It therefore facilitates creation of a high demand for the offer, and further consolidates the streaming of franking credits to low marginal tax-rate shareholders. Empirical evidence documents positive abnormal announcement returns for TOMBs and negative abnormal returns on the date that the scale-back is announced,[36] suggesting that low tax rate investors purchase shares to tender into the buyback and sell 'excess' shares on announcement of the scale-back. This strategy represents a form of trading in the franking credits. Thus, the buyback timeline creates distortions in demand for shares of companies undertaking TOMBs and flies in the face of the logic of the 45-day rule.

As previously stated, there appears to have been some violations of, or exemptions to the 45-day rule timing requirements. In 1997 and 1999 Commonwealth Bank completed the first two TOMBs (see Appendix 1 for the details of all 57 TOMBs), for which there were only 37 clear days from initial announcement to close of the tender. In order to claim franking credits on shares to be tendered into the buyback, investors needed to purchase *prior* to announcement of the buyback. Brown (2007) finds evidence of significant abnormal trading prior to the announcement of both Commonwealth Bank TOMBs. In both these cases, the buyback was foreshadowed in the previous AGM, and Brown suggests that there may have been anticipatory trading.

It appears that the BHP 2018 TOMB we have described in detail in Section 3 had only 43 clear days between announcement (1 November) and close of the tender (14 December). Nevertheless, in CR 2019/5 at paragraph 49, the ATO states that provided "the shares sold into the Buy-Back were acquired on or before 1 November 2018" they satisfy the 45-day rule. A similar example is the Woolworths 2010 TOMB. It had 43 clear days between announcement (26 August) and close (10 October). However, CR 2010/62 at paragraph 46 states that shares held at-risk and acquired on or before the announcement date will qualify for the franking credits.

The ability of investors to purchase shares on or after the announcement date and, through having met the 45-day holding rule, participate in the buyback to receive franking credits

[35] In a Class Ruling for each TOMB, the Commissioner states the date by which shareholders must have purchased the shares to 'qualify' for the franking credits.
[36] See Au Yong et al. n 17.

warrants question. While it meets the legal requirement of the 45-day rule it is inconsistent with the spirit and objective of that rule which was to prevent trading in franking credits. TOMBs enable and encourage such short term trading.

Tax Revenue Consequences

TOMBs enable “streaming” of franked dividends to those resident investors most able to gain benefit from them. High marginal tax rate investors do not participate, nor do foreign investors. This has potentially significant consequences for government tax revenue compared to distribution of those franking credits to all shareholders pro-rata, because the TOMB increases the proportion of franking credits generated by a company, which are ultimately redeemed by low or zero tax-rate residents. We take the case of a pro rata franked dividend to all shareholders as the appropriate counter-factual. To derive the difference in outcomes, we first consider the consequences for each type of shareholder according to their tax position, before aggregating to get the overall consequences.

Consider, for example, a company (with corporate tax rate 30%) distributing a $70 (cash amount) franked dividend to which is attached $30 of franking credits. Were that dividend paid exclusively to zero-tax-rate investors, the government would have a cash outflow of $30 through those investors claiming a rebate of the company tax paid. If it were paid to superannuation funds on a 15% tax rate, the government would have an effective cash outflow of $15 because of surplus franking credits received by the superannuation fund being offset against other taxable income. For high-tax-rate domestic investors on (say) a 50% tax rate, the government would have a cash inflow of $20 (since the taxable income of the investor would be $100 due to imputed income, tax liability would be $50, and only $30 of that would be offset by tax credits). If a franked dividend is paid to a resident taxpayer on a 30% tax rate there is no net government tax cash flow since tax credits received would just match the shareholder’s tax liability). It is therefore apparent that one tax cost to the government from TOMBs arises from the streaming of tax credits away from high marginal tax-rate domestic investors.

Another form of streaming arises from exclusion of foreign investors from participating in TOMBs. If instead a dividend were received by foreign investors who cannot claim the franking credits, no tax cash flow consequences would generally occur for the government. This is because the withholding tax rate on franked dividends is generally zero.[37] Thus, the tax cash flow consequences for the government would be equivalent to the franked dividend being paid to a resident taxpayer on a 30 per cent tax rate. Thus, exclusion of foreign shareholders from the TOMB means that, just as occurs with non-participation of high tax rate resident shareholders, tax credits are streamed to low tax rate participants, at a cost to government tax revenue.

This latter aspect of the streaming involved in a TOMB, that involving the non-participation of foreign shareholders, is recognised in regulation. In the ATO Practice Statement, PS LA 2007/9 the anti-avoidance provisions contained in paragraph 177EA(5)(a) of ITAA 1936, are used to determine a debit to the Franking Account Balance of a repurchasing company. This reflects

[37] See https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Australian-income-of-foreign-residents/Tax-on-Australian-income-for-foreign-residents/

the streaming of franking credits from non-resident to resident shareholders by exclusion of foreign shareholders from the TOMB and consequent "non-wastage" of those credits.[38] The ATO calculates the FAB debit for foreign ownership using the formula represented in Figure 1.

Figure 1: Calculation of FAB debit for foreign ownership (Source PS LA 2007/9, see n 36)

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Number of shares bought back x Franking credit attaching to each x Non-residents x 0.5*
30, 000, 000 x $2.31 x 0.29 x 0.5
= $10, 048, 500
* takes into account the fact that franking credit offsets withholding tax liability of 15%
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A debit to the Franking Account Balance has some merit to provide an offset to the streaming of franking credits to low tax-rate participants in TOMBs. In principle, it is not obvious why such a debit would be limited to franking credits that would have gone to foreigners rather than also to high-tax rate domestic shareholders who do not participate in the TOMB. But putting that aside, we are unable to find any logical explanation for the specific formula used.

To construct a numerical illustration of the costs involved in streaming of franking credits, we assume that the distribution by tax bracket corresponds to available aggregate data used by Treasury in 2018.[39] The example provided in Appendix 3 shows that the tax cash flow cost of the streaming of franking credits from high to low tax rate domestic investors is almost half of the total tax cash flow cost. The total cash flow cost in turn is an amount equal to around 2/3 of the value of franking credits distributed via the TOMB.

Appendix 3 illustrates the complexities involved in calculating an appropriate debit amount which would offset the cost to government tax cash flows from the streaming of franking credits of a TOMB. As we note there, by making a debit of $Z to the company's franking account balance, some amount $\$(1-t_c)Z/t_c$ (= 0.7Z/0.3) (where t_c is the corporate tax rate) of subsequent cash dividend payment will need to take the form of an unfranked dividend rather than a franked dividend. (Thus if the debit was Z= $30, and depleted the company's FAB, if a subsequent dividend of $70 were to be paid it would need to be unfranked rather than franked). If, hypothetically, all this were able to be paid to foreigner shareholders, the unfranked dividend would incur withholding tax of 15 per cent while the franked dividend would have been subject to a 0 per cent withholding tax rate. The government would receive tax cash flow of 0.15 x$70 = $10.50. But, assuming that the transfer of franking credits from foreigners in the TOMB was $60 (such that the ATO formula leads to Z = $30) the tax cash flow cost would be $\$60(w+0.5(1-w))$. In this formula, w is the proportion of zero tax rate TOMB participants (who are refunded franking credits received) and $(1-w)$ is the proportion of 15% tax rate TOMBs participants (who use 50 per cent of them to offset other tax liabilities). The TOMB tax cash flow effect is between $30 when $w = 0$ and $60 when $w = 1$, which is much higher than the recoupment following the FAB debit and subsequent payment of unfranked dividend to foreign shareholders. In practice, of course, the company cannot pay the unfranked dividend solely to

[38] The ATO has confirmed the practice of debiting of the FAB for the portion of foreign shareholders on the share register. See Paragraph 126 of PSLA 2007/9 for an example of how the formula is applied: https://www.ato.gov.au/law/view/document?Docid=PSR/PS20079/NAT/ATO/00001&PiT=99991231235958
[39] See n 14.

foreign shareholders, such that a much more complex calculation would be required as shown in Appendix 3.

We conclude that: (a) the formula used for debiting the FAB for the share of franking credits which would otherwise have gone to foreigners is inappropriate; (b) the appropriate formula would depend upon the distribution by tax status of shareholders and TOMBs participants; and (c) the appropriate adjustment should also allow for streaming of franking credits from higher tax rate domestic shareholders.

Aggregate tax revenue consequences

To conclude this section, we provide a ball park estimate of the consequences to government tax revenue of permitting TOMBs, rather than requiring companies to distribute franking credits *pro rata* to all shareholders. First, we assume that the average tax rate of domestic shareholders in Australian companies is 30 per cent. Second, we note that in considering government tax flow consequences of franking credit distribution, we can treat foreign shareholders as similar to 30 per cent tax rate domestic shareholders. (There are no tax cash flow consequences if zero withholding tax applies, as explained above). We assume that the average tax rate of TOMBs participants is 10 per cent (assuming 1/3 are zero tax rate investors and 2/3 are 15 per cent tax rate investors). We assume that 40 per cent of shareholders are foreigners.[40]

Table 5: TOMB government tax flow consequences

	TOMB (1/3 of tax credits flow to zero rate investors who receive rebates of that amount, while 2/3 flow to 15% tax rate investors who can use them to reduce their tax bill on other income by half the amount received)	Pro rata franked dividend (assuming average investor tax rate is 30 per cent, and foreign investors pay no withholding tax)
Government tax cash outflow if \$70 cash dividend with \$30 of franking credits distributed	(1/3) x \$30 + (2/3) x \$15 = \$20	\$0
FAB foreign investor adjustment assuming foreign investors are 40% of share register.	-\$30 x 0.4 x 0.5 = - \$6	\$0
Net cost	\$14	\$0

[40] As at June 2009 on the ASX, 20 percent of shares were owned by retail (domestic) shareholders and slightly more (less) than 40 percent by foreign (domestic) institutional shareholders. See ASX (2010): Capital raising in Australia: Experiences and Lessons from the Global financial Crisis. https://www.asx.com.au/documents/media/20100129_asx_information_paper_capital_raising_in_australia.pdf

In Table 5 we illustrate the government tax cash flow consequences of a TOMB involving a franked dividend of \$70 with \$30 of attached tax credits compared to a *pro rata* franked dividend of the same amount to all shareholders. The ball-park calculations documented in Table 5 suggest that the cost to government revenue from TOMBs (after allowing for, on our analysis insufficient, FAB debit for foreign shareholders) is in the vicinity of 50 per cent of the franking credits distributed. In 2018, TOMBs involved the distribution of \$4.217 billion of franking credits, implying a cost to government tax revenue in the order of \$2 billion dollars in that single year!

This cost to government tax revenue is of significant size. As we show in Section 6, there are alternative mechanisms available for companies to distribute cash to shareholders that do not involve such an effect. Before considering those alternatives we address the question of whether there is some logical justification for allowing TOMBs involving such complicated regulatory and tax arrangements.

5. Can the TOMBs structure be justified?

Given the complex structure of TOMBs and the regulatory and tax complications arising, why should companies be allowed to structure buybacks in this way?

It can be argued that the regulatory and tax treatment, even though appearing anomalous, has some economic logic behind it.[41] That logic involves thinking of a buyback as being akin to a liquidation of part of the company, and noting that in a liquidation some part of the funds disbursed to shareholders is a return of capital and some part a distribution of accumulated profits. The capital component is subject to the capital gains tax rules and distribution of accumulated profits treated as a dividend (which would be franked if the company has an adequate franking account balance).

On this logic, the buyback could be thought of as analogous to a division of the company into two parts – one of which (A) is to be liquidated and the other (B) ongoing. In the analogy, shareholders receive pro rata shares in both parts, and would be able to trade shares in one part for shares in the other with other shareholders. A relative price between the A and B shares (P_A and P_B) would be established based on investor tax preferences, with P_A akin to the buyback price and P_B akin to the market price. Some investors, who after trade are holding only A shares (the part to be liquidated) ultimately receive a cash amount comprising capital and franked dividends, just as in a buyback. (While the analogy makes no distinction between domestic and foreign shareholders, the exclusion of the latter from participation in TOMBs weakens the precision of the analogy and determination of the equilibrium price).

In the analogy, these cash amounts received would be subject to tax under income tax and capital gains rules. This also applies for TOMBs, other than the Tax Value adjustment whose rationale is explained elsewhere in the paper. However, there is some logic to limiting the capital losses available to participants, as argued by the Australian Board of Taxation (2008) based on the cost to government tax revenue, and resulting from complications inherent in the capital gains tax regime.

Consider first an argument that there should be no restrictions on the claiming of tax losses. Essentially, participants in the buyback who claim tax losses will have bought shares on the market at a higher price than the capital component. The investors who had sold them those

[41] See, for example, the discussion at Board of Taxation Report op cit. para 4.31.

shares (or some previous sellers in a chain of sales) will have been subject to capital gains tax on the difference between their sale price and the capital component (essentially, over the entire history of the company, the subscribed capital). Thus, in principle, the tax losses offset previous capital gains tax payments with the net effect (ignoring timing and other complications) being that overall government tax revenue from return of capital subscribed is, as it should be, zero.

However, as the Australian Board of Taxation[42] noted, previous sellers of shares in the company may not have been subject to "full" taxation on their capital gains. Non-resident investors do not generally pay capital gains tax on sale of shares, and domestic investors who have sold shares after a holding period of one year or more are taxed on capital gains at a concessional rate. Given these tax distortions, there is a "tax neutrality type" argument (albeit one which has not been subject to empirical analysis) for disallowing notional capital losses calculated relative to the capital component of off-market buybacks, as was proposed by the Australian Board of Taxation and incorporated into the, ultimately discarded, draft legislation of 2011.

6. Alternatives to TOMBS

TOMBs enable self-selection by shareholders regarding their participation in order to simultaneously receive franked dividends and sell shares back to the company for capital gain or loss. As we have shown, that has consequences for government revenue and for distributional implications among shareholders which can elicit concerns respectively, of inappropriate tax arbitrage and fairness.

Ignoring the issue of which shareholders participate in TOMBs, it is clear that a company undertaking capital management activities can achieve the same cash flow and accounting outcomes in other ways. The most obvious is via declaration of a special dividend and a pro-rata return of capital to all shareholders. Taking the 2018 BHP TOMB considered in Section 3, a special dividend of $2.26 and a return of capital of $0.03 per share would achieve the same cash flow outcome for the company, although with different consequences for shareholders due to the participation of all shareholders.[43] Government tax revenue would be differently affected (improved) due to the allocation of franking credits to all shareholders rather than just the low-tax-rate investors participating in the TOMB. Investors would not be subject to realisation of capital gains or losses and current tax consequences, but would face a reduction in the cost base of their shares (from the return of capital), with subsequent consequences for realised gains or losses at some future date.

The return of capital would leave the number of shares outstanding unaffected and, combined with the dividend payment, would reduce the company share price relative to the case of the TOMB (where the number of shares outstanding declines). If that were thought to be an issue, it could be offset by using a pro-rata repurchase of shares rather than a return of capital, or combining the return of capital with a share consolidation to offset the effect on the share price.

Undertaking some combination of special dividend and return of capital/share repurchase, achieves the same outcome for the company, but with different distributional consequences for the shareholder base. The TOMB concentrates tax benefits upon low-tax rate investors at the

[42] See Board of Tax Report (n. 12) at paras 4.30 - 4.50.
[43] The buyback was for 8.3% of shares on issue. Thus for the same aggregate outlay, the payment per share on all shares would be 8.3% of the TOMB: $27.26 dividend and $0.38 capital return.

expense of government tax revenue, compared to a *pro rata* special dividend. In practice, the scale-back arising because of the 14 per cent discount cap alters the distribution of those tax benefits from a TOMB. Absent the cap, low-tax-rate investors wishing to participate would likely have competed away much of their tax-benefits by offering to sell at lower prices. This would have transferred benefits to non-participants via the larger uplift in the post-TOMB share price. Unfortunately, it is impossible to reach general conclusions about the relative distribution of benefits between taxpayer groups of a TOMB (with or without the discount cap) versus a *pro rata* special dividend. Nevertheless, companies are likely to consider distributional consequences resulting from their special circumstances as one factor in deciding between special dividends and TOMBs.[44]

7. Conclusion

We have demonstrated the considerable complexity of the TOMBs structure and of regulatory and tax arrangements. There is considerable cost to government tax revenue, which we have estimated to have been in the order of $2 billion in 2018, due to the streaming of tax credits to low tax rate investors. We have shown that while the ATO applies a debit to the company's FAB to offset the streaming of franking credits away from foreign investors, the calculation of that amount (which is not well explained in ATO literature) is arguably inadequate to completely offset the streaming consequences for government tax revenue. Moreover, there is no adjustment for the streaming effect between high and low/zero tax-rate domestic investors, which is a substantial cost to government revenue. Our ball-park estimates in Table 5 suggest that this is an amount equivalent to around half of the amount of franking credits distributed.

We have outlined how the regulatory and tax treatment of TOMBs have changed over time, reflecting in our view the difficulties in determining an appropriate approach to dealing with their complex structure and inadequate logical underpinnings for determining such an approach. The time involved in drafting and ultimately rejecting legislation to implement the Australian Board of Taxation recommendations of 2011 (which we have argued have some merit if TOMBs are to be permitted) is indicative of these issues. We have noted that some of the requirements (such as the 45-day rule for use of franking credits) appear to be not strictly enforced, and that allowing post-announcement purchase and participation to receive franking credits is inconsistent with the logic and spirit of the 45-day holding period rule.

We have shown that the complex rules, such as the 14% maximum discount, lead to the tax arbitrage benefits not being fairly shared with non-participating shareholders. The rule also generally leads to scaling back of offers made by participants replacing partially (at least) price uncertainty with quantitative uncertainty over outcomes. The magnitude of the scale-backs appear to be related to the excess demand for the offer partly created by the buyback timeline allowed by the ATO.

We have shown that while small in number, TOMBs are large in scale with significant adverse consequences for government revenue. Companies using TOMBs are generally very large

[44] The relative effects of a TOMB versus a special dividend on net wealth of different tax-rate shareholder groups will depend *inter alia* upon the post-distribution share price, distribution amount, buyback size relative to total shareholdings, shareholder composition.

companies. The beneficiaries of this are shareholders already receiving low or zero concessional tax rates, such as superannuation funds, endowments and charities.

We have shown that there are alternative simpler mechanisms for companies to distribute cash and franking credits to shareholders. These do not create the same concerns over fair treatment of different groups of shareholders, nor do they have the same adverse consequences for government revenue. These alternatives comply with standard legislation, regulation and tax arrangements and do not require the complex additional arrangements which TOMBs generate.

On these grounds we argue that the death-knell should be sounded for TOMBs. In doing so we note that the investor participant base of low tax-rate investors, who benefit from TOMBs, includes potentially significant lobby groups from the charitable and superannuation sectors. It is thus highly unlikely that our recommendation would not be subject to push back from such lobby groups.

Appendix 1

The table describes the types of share repurchases permitted for ASX (Australian Securities Exchange) listed companies in Australia under the *Corporations Act 2001 (Cth)*. To undertake a repurchase, companies must comply with Chapter 2J, Part 2J.1, Division 2 of the Corporations Act (2001). Each type involves different legal and disclosure formalities. In general, companies are able to repurchase up to 10 percent of their ordinary shares in any 12-month period (commonly referred to as the 10/12 limit) and once the transaction is completed the shares must be cancelled and the Australian Securities and Investment Commission (ASIC) notified. Company conduct during an on-market repurchase is constrained by ASX Listing Rules 3.8A, 7.29 and 7.33.

Type of repurchase	**Description**
On-market	Repurchases undertaken in the course of ordinary trading on the Australian Securities Exchange (ASX). Shareholder approval via an ordinary resolution is required only if the 10/12 limit is exceeded. Company conduct during an on-market repurchase is constrained by Listing Rules 3.8A, 7.29 and 7.33.[45] Sections 257H and 254Y of *The Corporations Act 2001* require cancellation of the shares immediately after they have been registered to the company.
Equal access	Repurchases where the company makes an offer to each shareholder to repurchase some or all of each shareholder's ordinary shares. They are conducted "off-market" and set at a price specified by the company. The proposed repurchase must be approved by a shareholder-approved ordinary resolution if it exceeds the 10/12 limit. Companies seek 'relief' from ASIC because various features of the 'equal-access' buyback do not strictly give equal access to all shareholders.
Selective	Off-market repurchases made by a company where shares are acquired from specified shareholders, to the exclusion of others, at a specified price. Offers may also pertain to holders of shares other than ordinary shares. A selective buyback must be approved by all 75% of shareholders (with no votes being cast by those holders whose shares are to be repurchased).
Minimum holding	Off-market repurchases of all of a holder's shares if the number of shares held is less than a "marketable" parcel. No resolution is required.
Employee share scheme	The acquisition of shares in a company by, or on behalf of, employees or directors who are employed by the company, or a related corporate body. Shareholder approval via an ordinary resolution is only required if the 10/12 limit is exceeded.

[45] The consequence of this legal framework can be summarized as follows: (i) When companies announce the buyback they are required to lodge a proforma announcement notice (Appendix 3C). Under Listing Rule 3.8A a company undertaking an on-market buyback must lodge an Appendix 3E, which is a daily notification at least half an hour before the start of trading on the business day after which any shares are bought back. Companies may repurchase shares only if transactions in the company's shares were recorded on ASX on at least 5 days in the three months before it buys back shares (Listing Rule 7.29). A company may buy back shares at a price which is not more than 5% above the average of the market price for securities in that class (Listing Rule 7.33).

Appendix 2

Name	Announce-ment date (t=0)	days t=0 to close	BB price/ Price at close	Proportion bought (%)	Size ($m)	Franked Div/ Buyback price (%)	Franking credits distributed ($m)	Scaleback
CBA 1	12/11/1997	37.00	0.99	4.0	650.63	59.02	164.56	0.297
CBA 2	10/02/1999	37.00	0.91	2.9	650.77	62.15	173.35	0.39
Wattyl	17/05/1999	32.00	1.05	7.7	28.98	58.13	7.22	0.402
Carlton Investments Limited	30/09/1999	34.00	1.19	3.2	11.13	60.00	2.86	0
Woolworths 1	14/02/2000	39.00	0.93	8.7	491.96	50.20	105.85	0.457
Lend Lease Corporation Ltd	18/08/2000	42.00	0.96	17.2	1754.94	64.79	487.29	0.575
CBA 4	13/02/2001	45.00	0.97	2.0	699.96	64.08	192.23	0.947
IAG (NRMA)	02/03/2001	75.00	0.87	9.6	404.16	34.56	59.86	0.862
Bank of Qld	06/04/2001	70.00	0.99	5.9	24.97	51.16	5.47	0.708
Woolworths 2	30/04/2001	46.00	0.83	3.7	348.21	66.90	99.83	0.424
Santos	17/10/2001	44.00	0.98	6.5	250.00	57.37	61.47	0.675
TAB Limited	21/03/2002	55.00	0.96	9.8	134.01	14.23	8.17	0
Insurance Australia Group (Ltd)	06/05/2002	45.00	0.97	7.0	298.47	41.64	53.26	0
Seven Network 2	27/08/2002	52.00	1.03	10.5	130.20	65.00	36.27	0.710
Woolworths 3	24/02/2003	46.00	0.92	4.4	531.91	74.74	170.37	0
Telstra	03/10/2003	49.00	0.85	1.9	1000.57	64.29	275.67	0.656
Seven Network 3	24/10/2003	49.00	1.03	13.4	193.87	40.00	33.23	0
Fosters	06/11/2003	43.00	0.89	7.6	668.43	54.75	156.84	0
CBA 5	11/02/2004	44.00	0.83	1.5	532.42	60.00	136.91	0
Insurance Australia Group (IAG)	30/04/2004	49.00	0.88	5.6	413.96	59.55	105.64	0
Westpac Banking Corp	06/05/2004	43.00	0.84	2.1	558.58	72.41	173.35	0
Telstra	27/09/2004	46.00	0.86	3.0	750.40	62.96	202.49	0.113

BHP Billiton	05/10/2004	45.00	0.87	4.8	2271.61	83.29	810.90	0
Bluescope Steel Ltd	23/02/2005	44.00	0.89	3.5	200.39	60.39	51.86	0
Corporate Express Australia Ltd	01/03/2005	45.00	0.89	3.3	35.28	94.64	14.31	0
Rio Tinto Ltd	11/03/2005	56.00	0.84	5.5	1001.69	89.10	382.51	0
Coles Myer Ltd	17/03/2005	64.00	0.91	5.7	584.60	63.86	159.99	0
Westpac Banking Corp	02/11/2005	44.00	0.85	2.8	1000.00	79.09	338.96	0.038
St George Bank	16/12/2005	63.00	0.85	2.2	300.00	74.54	95.84	0.708
BHP Billiton	15/02/2006	44.00	0.84	2.7	2250.05	91.04	877.95	0.635
Coles Myer Ltd	23/05/2006	45.00	0.86	6.5	836.98	70.67	253.55	0
BHP Billiton	7/02/2007	47.00	0.83	4.0	3500.66	89.92	1349.10	0.6243
Corporate Express Australia Ltd	8/02/2007	53.00	0.87	9.2	90.02	94.34	36.40	0.6095
Foster's Group	20/02/2007	44.00	0.87	3.3	400.01	69.32	118.84	0.420
Alumina	5/03/2007	46.00	0.89	3.3	250.06	94.44	101.22	0.7975
Just Group	7/03/2007	51.00	0.86	7.6	65.01	97.44	27.15	0.598
Santos	14/05/2007	46.00	0.95	4.1	300.00	77.06	99.07	0.609
Boral Limited	13/02/2008	51.00	0.85	3.3	113.11	49.73	24.11	0
Santos Limited	21/08/2008	43.00	0.92	3.1	300.05	81.64	104.98	0.592
Woolworths	26/08/2010	43.00	1.04	2.2	704.30	87.98	265.56	0.882
BHP Billiton	22/02/2011	45.00	0.86	4.4	6000.86	99.31	2554.17	0.783
JBHi-Fi Pty Ltd	29/03/2011	45.00	0.88	9.9	173.33	96.38	71.59	0.811
Perpetual Limited	26/08/2011	49.00	0.82	7.5	70.01	55.89	16.77	0.681
Telstra	14/08/2014	50.00	0.85	1.7	1000.13	49.35	211.52	0.698
Rio Tinto Ltd	12/02/2015	49.00	0.87	0.4	560.27	80.51	193.32	0.910
Caltex Australia	23/02/2016	45.00	0.85	3.4	270.08	93.16	107.83	0.861
Insurance Australia Group	19/08/2016	49.00	0.89	2.6	313.55	39.10	52.55	0
Telstra Corporation Limited	11/08/2016	50.00	0.86	2.3	1250.00	59.82	320.46	0.842

Rio Tinto Ltd	22/09/2017	49.00	0.87	2.8	749.91	85.17	273.74	0.893
Rio Tinto Limited	20/09/2018	50.00	0.86	10.0	2871.10	86.45	1063.79	0.583
BHP Billiton Limited	1/11/2018	43.00	0.85	8.3	7347.81	98.63	3105.77	0.587
Metcash	25/06/2018	46.00	0.83	6.8	150.03	73.01	46.94	0.723

Appendix 3

In this appendix, we demonstrate the consequences for government tax cash flows arising from a company's use of a TOMB rather than a pro rata franked dividend. We then consider the consequences for government tax cash flows of the "ad hoc" debit made by the ATO to the company's FAB following a TOMB. We assume that this leads to the company having to subsequently distribute some specific amount of cash (if it wishes to do so) by payment of an unfranked rather than a franked dividend. Because the outcomes depend on the composition of shareholders according to tax bracket, we assume a specific distribution of shareholders consistent with available data.

Model:

We assume a company initially with a Franking Account Balance of $36 and cash available for distribution as dividends of $84. We ignore the cash payout of the capital component of the TOMB. We assume that the TOMB includes a $70 franked dividend with $30 franking credits (FC) attached

The shareholder composition by tax status is assumed to be[46]:

Tax bracket	0%	15%	30%	50%	Foreign
Proportion of shareholders	0.1	0.15	0.1	0.25	0.4

We assume that only 0% and 15% rate shareholders participate in the TOMB in equal amount (50% each).

Following the TOMB, the ATO debits the company FAB according to its formula by an additional $6 = $30 × 0.4 × 0.5 (franking credits distributed × proportion of foreign shareholders × 0.5). This reduces the magnitude of franked dividends that the company can subsequently pay, by $14 in this example. We assume that the company subsequently pays remaining cash out as a $14 unfranked dividend.

We first consider the government tax revenue consequences of the TOMB versus the counterfactual of paying a pro rata franked dividend. Assume that the withholding tax on franked dividends paid to foreigners is 0. For the TOMB the government will pay rebates to 0% rate participants, 15% rate participants will claim half of Franking Credits received against other tax liabilities.

	tax bracket	0%	15%	30%	50%	Foreign	Total
TOMB							
	cash received	35	35	0	0	0	
	FC received	15	15	0	0	0	
	Govt tax cash flow	-15	-7.5				-22.5
Pro rata Franked Dividend							
	cash received	7	10.5	7	17.5	28	
	FC received	3	4.5	3	7.5	12	
	Govt tax cash flow	-3	-2.25	0	5	0	-0.25

[46] See n13. Treasury figures are in line with these assumptions.

Thus, in this case, government tax cash flow from the TOMB is -22.5, whereas in the alternative case of a pro rata franked dividend it is -0.25. This arises from the TOMB leading, relative to a pro rata dividend, to the transfer of $12 franking credits from foreigners and $10.5 franking credits from 30% and 50% tax rate domestic shareholders to the TOMB participants.

The tax cash flow consequences of the $12 credits transferred from foreigners is $9 (since $6 go to 0% tax rate investors who get rebates of $6, and $6 go to 15% tax rate investors who use them to offset $3 of tax on other income). The debit to the FAB of $6 made by the ATO has no apparent relationship to this tax cash flow cost. However, it may be justifiable since, if available cash flow is to be distributed as a dividend, the debit requires that it be an unfranked rather than a franked dividend.

We calculate the subsequent tax cash flow consequences for the government in that case where withholding tax is 15% for an unfranked dividend and 0% for franked dividends received by foreigners. We compare the government revenue consequences for the subsequent unfranked versus franked dividend of $14 (reflecting debit made by ATO to company FAB of $6).

	tax bracket	0%	15%	30%	50%	Foreign	Total
Franked dividend							
	cash received	1.4	2.1	1.4	3.5	5.6	
	FC received	0.6	0.9	0.6	1.5	2.4	
	Govt tax cash flow	-0.6	-0.45	0	1	0	-0.05
Unfranked dividend							
	cash received	1.4	2.1	1.4	3.5	5.6	
	FC received	0	0	0	0	0	
	Govt tax cash flow	0	0.315	0.42	1.75	1.68	4.165

By debiting the company FAB such that a subsequent unfranked dividend replaces a franked dividend:

(a) the government receives a net tax cash flow benefit of $4.16
(b) this is due to the formula used to make the FAB deduction and depends upon the shareholder composition
(c) it is not related to any change in the tax cash flows between government and foreigners as a result of the TOMB replacing a pro rata dividend, because franked dividends have a zero withholding tax rate and the government tax flow consequences are zero in both cases
(d) the total government tax cash flow consequences of the TOMB excluding foreign shareholders and the additional debit to the FAB leading to an unfranked rather than franked dividend are +$4.165 - $9 = -$4.835. (Note that only $1.68 of the $4.165 is tax cash flows from foreigners with the rest from domestic shareholders).

We conclude that there appears to be no logic to the formula used by the ATO for debiting the company FAB following a TOMB.