Noise, but not much logic in opposition to budget announcement re treatment of off-market-buybacks

The vociferous adverse reaction of various vested interest groups to the Budget announcement to amend the tax treatment of off-market buybacks is hardly surprising. It's a pity that it's so misguided and based on poor logic. Sure, there'll be some shareholders who lose but also a lot that win (not to mention the government budget benefit and the integrity of our tax system)!

What is the proposed change? The budget is sparse on details, other than a proposal to align the treatment with on-market buybacks. That seems pretty innocuous and sensible.

What will likely happen is that the inclusion of franking credits in the price paid to participating sellers in the off-market buyback would not be allowed. This would align the situation not just with on-market buybacks, but also with the situation everywhere else in the world.

An obvious consequence is that off-market buybacks would no longer occur at a discount to current market price, but rather at a premium as occurs in other markets. (The reason for a premium is that participation involves realisation of any historical capital gains for the investor and consequent current tax liabilities – only worthwhile if a higher price than the current market price is received).

It is the fact that some (zero or low tax rate) investors are willing to offer to sell shares at a discount to the market price (together with the ATO 14 per cent limit on the maximum discount) that is the key to understanding why the budget announcement makes sense on both economic and equity grounds.

Were there no limit on the size of the discount, competition to participate and get those valuable franking credits would drive the buyback price to a discount at which the loss from the discounted price is just offset by the value of the franking credits received. This is indicated clearly by the size of the "scale-backs" (offers rejected relative to total applications at the 14 per cent discount maximum) which average over 60 per cent.

We have previously estimated that market equilibrium discount to be over 20 per cent.

In that situation there would be no net gains for participants (although the somewhat arbitrary capital gains tax treatment by the ATO of the capital component might leave some participants with a small benefit). In that situation, the much larger group of non-participating shareholders would also have no net gain or loss. (They lose because of the "streaming" of franking credits to participants, but gain because the company has bought back shares of participants at a "fair" discount to the market price).

But, the 14 per cent maximum discount distorts things to the benefit of participants and creates losses for non-participants. Participants would have been willing to accept a much larger discount.

Consequently, a small select group of investors (including rich SMSFs and others able to structure their tax affairs to have a zero marginal tax rate) benefit at the expense of all other investors. That's hardly fair!

And, of course, the government's budget revenue, and ability to provide public services suffers from the streaming of tax credits to low- tax-rate participants and away from other investors. This latter group includes foreign investors who are unable to use the imputation credits (unless smart investment bankers find loopholes in the tax laws – which they have in the past!)

Preventing tax-driven off-market buybacks (TOMBs as we have called them) doesn't constrain companies in any substantive way. They can still distribute franking credits as part of special dividends. They can still return un-needed capital to shareholders via ordinary buybacks.

Shareholders can still get the benefits of franking credits created by company tax payments. But rather than only a few shareholders getting an excessive share of those credits, all shareholders receive them pro-rata. This is clearly equitable, except perhaps to foreign shareholders who cannot use the credits (a consequence of our imputation tax system).

And we should all be aware that the number of "winners" under the current arrangements is really quite small relative to the the bulk of shareholders who lose out. (Generally, only around 5 per cent of outstanding shares are bought back).

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