Submission to the Board of Taxation
on the Review of the Taxation Treatment of Off-market Share Buybacks

by

National Institute of Accountants

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The National Institute of Accountants (NIA) is one of the three professional accounting bodies in Australia, representing over 14,000 members in Australia and overseas. Members of the NIA work in all fields of accounting including in private practice, government, industry and academia. The NIA is actively involved in setting and enforcing professional standards and in reviewing and commenting on legislation at all levels. Many of our members either work in or advise on taxation and superannuation. The adequacy of the taxation and superannuation systems to meet the expectations of current and future retirees is a popular topic with our members.

As a professional accounting body the NIA's key roles include:

- offering post-graduate study in accounting Professional Education Program (PEP) – a Master of Commerce (Professional Accounting) from the University of New England;
- conducting quality review of members in public practice, instigating investigations and where necessary discipline against members who have breached the NIA's professional and ethical requirements;
- offering Continued Professional Education for all members (and non-members);
- providing members with information about legislative, regulatory and other changes that are affecting or may affect them;
- advocating on behalf of members and the profession as a whole, on issues of national importance;
- liaising with regulatory bodies on issues affecting members, particularly in the areas of taxation, superannuation, financial services, Corporations Law and accounting and auditing standards;
- setting and enforcing professional and ethical standards; and
- promoting issues of importance in the accounting profession.

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Introductory comments

The National Institute of Accountants (NIA) welcomes the opportunity to make a submission to the Board of Taxation's Review of the Taxation Treatment of Off-market Share Buybacks.

Many of the NIA's members are in the position of having to provide tax or financial advice to their clients on off-market share buyback offers for listed companies, many of these clients being small retail investors ('mum and dad' shareholders) for whom the common question is – 'what should I do?' Accordingly, we have focused mainly on issues and considerations arising from off-market share buybacks of listed companies from the perspective of our members and their clients. For them, the answer to the question of how to respond to an off-market share buyback will depend on numerous factors, including which shareholder category they fall into.

This in turn raises the issue of horizontal equity between shareholders, which broadly relates to the issues and questions contained in chapter 5 of the discussion paper and to the term of reference – 'the implications of the current taxation treatment of off-market share buybacks for different types of shareholders'.

The NIA has also made various observations and comments on other aspects of off-market share buybacks which form part of the broader environment in which shareholders must make a decision about whether or not to participate in a buyback.

Summary of NIA position

Whilst broadly agreeing that off-market share buybacks are an appropriate mechanism for companies to improve their capital management, the issue of whether there is equity between different types of shareholders should be further considered. The obvious starting points might be the calculation for the market value of shares and the discount rate applied to the repurchase. If an optimal position is to be reached, as far as practicable, then any possible adjustments to these factors could be the subject of further, targeted consultation with stakeholders and detailed modelling work.

The dilemma for shareholders is whether they can benefit more from participating in the buyback and selling their shares or whether not to participate and reap the longer term benefits of an increased share price and a more efficient and profitable company. Each shareholder has to assess their position based on numerous factors including, what they originally paid for the shares and their marginal tax rate. The NIA continues to ensure that its members and their clients provide and receive the best possible advice when faced with this decision.

Equity between shareholders
Questions 5.13, 5.14, 5.17

The NIA broadly agrees with the views expressed in the discussion paper that the current arrangements for off-market share buybacks provide companies with a 'fast and efficient means to distribute both excess cash and excess franking credits to the group of shareholders who find it beneficial to participate' (page 52 paragraph 5.5). However, this highlights one of the main issues with off-market share buybacks – whether there are types of shareholders who find it beneficial to participate, relative to other types of shareholders, and whether this is the correct outcome.

Given that one of the policy benchmarks for considering the appropriate tax treatment of off-market share buybacks is equity then it is assumed that all shareholders should benefit equally subject to trade-offs with the other main policy objectives of efficiency and simplicity (pages 14-16 of the discussion paper).

It is unquestionably difficult to precisely calculate the benefits of off-market share buybacks for the various types of shareholders, the company and the economy in general. There is the perception or belief held by some commentators that off-market share buybacks have been controversial because they 'discriminate' against ordinary shareholders and favour institutional investors, certain charities and taxpayers on low marginal tax rates. There is also the concern about lost revenue and what this means for all taxpayers, especially given the recent increasing trend for off-market share buybacks. Various studies and other empirical evidence are often cited in support of these propositions and the discussion paper canvasses numerous studies in this regard.

A matter of balance
Questions 5.13, 5.14, 5.17

The NIA believes that whether or not to participate in an off-market share buyback is usually a balancing act depending on many factors and taking into consideration the positions of the company, the type of buyback and the circumstances of the shareholder.

From the shareholder's perspective, there is more to consider than just the marginal tax rate. Each buyback is different with different terms and conditions influencing the decision, such as the discount rate, the repurchase price, the shareholder's cost base, the shareholder's investment profile, the current market conditions, the financial position of the company and so on. There could also be tax benefits for shareholders with small parcels of shares as companies sometimes try to encourage small shareholders to sell. Also, no transaction costs are involved, which is beneficial to shareholders.

From the company's perspective there are numerous factors at play when considering which form of capital management is preferable for shareholders – off-market share buybacks, on-market share buybacks or distributing dividends. The price at which a company repurchases its shares is critical to the decision, with flow-on effects for all non-participating shareholders. It can be argued that the repurchase price does not affect the extent of the company's more efficient use of capital because return on equity (ROE) should increase in the same amount. The repurchase price will have an effect on the return to shareholders in that the higher the repurchase price, the higher the return for those who sell and the lower the return for non-participants.

However, critics such as the Melbourne Centre for Financial Studies believe that buybacks are unfair. Often the position is that the additional tax payable for those on higher marginal tax rates on the franked dividend component means that it is often more beneficial to sell shares on-market. The issue of equity they say is that participants in the buyback are receiving franking credits at the expense of non-participants.

Apart from looking at the benefits on a micro (individual) basis, it is also possible to consider the macro (aggregate) impact. So that, if the value given up by the non-participating shareholders is less than the benefit received from repurchasing and cancelling shares at a price below market price then it may be better not to participate. If undistributed franking credits are fully valued then non-participating shareholders may be worse off.

If the tax treatment between different types of shareholders is not neutral then this would seem to contradict the requirement that company boards are expected to treat all shareholders equally. However, arguably this would require a balancing of the short term benefits to participating shareholders against the longer term benefits to non-participating shareholders. In any event, this does not seem to be a major consideration affecting the trend toward off-market share buybacks.

It is interesting to note that during a Senate Economics Legislation Committee hearing in November 2004, that Treasury was asked the question whether it has any estimate of the projected cost of concessionary tax treatment of off-market share buybacks in light of recent announcements by large Australian companies such as BHP, Telstra and Westpac. Treasury's response was 'No. The tax treatment of off-market share buybacks is not concessional'. This begs the question as to what is meant by 'concessional' and whilst it may be arguable that the tax treatment is not concessional per se, there is the additional question of whether the tax treatment leads to concessional (or favourable) outcomes for certain types of shareholders relative to other types of shareholders. As mentioned above, most of the evidence canvassed would appear to lead to this conclusion.

'Good' vs 'bad' buybacks
Question 2.1

Some commentators divide off-market share buybacks into 'good' buybacks and 'bad' buybacks.

The 'good' buybacks are characterized by the objective of repurchasing shares at the lowest possible price (which is beneficial to non-participants). There is a huge amount of analysis on when companies should engage in buybacks in terms of buying when their share price is low (why buy shares when the price is high).

Warren Buffett said that a company can add to its shares by buying some of them back where it has surplus funds; and where it can buy them back at a price below intrinsic value. He also said that it was an 'ignoble reason' to offer a share buyback to pump up or support the stock price. The shareholder who chooses to sell today is benefited by any buyer, whatever his origin or motives but the continuing shareholder is penalized by repurchases above intrinsic value. He said, 'Buying dollar bills for $1.10 is not good business for those who stick around.'

'Bad' buybacks are those where the company is simply using the buyback to inflate its own share price. One study in the US found that of 409 of America's largest companies which announced buybacks, nearly 40% failed to repurchase shares in the five year period following the buyback announcement. This can be compounded where a company uses debt to repurchase its shares (or intends to use debt).

Studies in Australia have shown that contrary to these reports, companies, on average, repurchase almost 75 per cent of the announced targeted level of shares and around 30 per cent continue to repurchase shares even after completing the initially announced buyback level.

It could be argued that 'good' buybacks seem to attract value investors rather than speculators who might be attracted to 'bad' buybacks. Warren Buffett is often used as an example to show the value of 'good' buybacks in that he has participated in buybacks whilst on the board of various companies which have gone on to benefit shareholders. Berkshire Hathaway does not engage in repurchasing its shares. In fact, a 'good' buyback may indicate, ceterus paribus, that the shares of the company are worth holding (especially for longer term investors). The converse may also hold true with respect to 'bad' buybacks. Also, when there is a lack of good prospects in the market and shares are underperforming, then it creates a good environment for buybacks.

In summary, if undertaken for the right reasons and undertaken appropriately, share buybacks can improve a company's capital management position and increase its earnings per share, which in turn, over the longer term should see benefits flowing to shareholders through the effect of increasing the share price and improving ROE.

Other reasons for share buybacks
Question 2.1

In addition to the reasons given on pages 10 and 11 of the discussion paper, there are other reasons given for why companies may engage in an off-market share buybacks. These are:

- As an anti-takeover mechanism by increasing leverage and reducing liquidity.
- Wealth transfer when shares are undervalued from participating (selling) shareholders to non-participating shareholders.
- In the US, the favourable tax treatment has been given as another reason for share buybacks.

One of the usual reasons given for some off-market share buybacks is that they are in response to strong profits but others can be defensive, for instance, looking to reduce their cash holdings to make themselves less attractive to private equity firms (that is, increasing gearing by increasing the debt/equity ratio).

Also, with investors chasing increased yields (especially as more people retire and need alternative income streams) this drives dividend payouts higher and encourages greater use of share buybacks.

Another consideration in this context is whether companies negate the objective of a buyback by reissuing shares. Studies in the US have shown that even though companies are handing back capital to shareholders (through buybacks and dividends) there are actually more shares being issued, whether to finance acquisitions or for other purposes. Studies in the US over a ten year period have shown that companies in the S&P 500 have, overall, been net issuers of shares.

There is also the consideration of companies issuing options over their shares, especially for executive remuneration, which can also have the effect of not reducing the number of issued shares.

Alternatives to off-market share buybacks
Question 2.2

In some scenarios it is possible that the return will be lower under an off-market share buyback than it would be from a dividend. On the other hand, the lower the buyback price, the lower the return for those who sell and the higher the return for non-participants. It may be true to say that the extent to which a company's shares are undervalued; the more beneficial will be a buyback. Otherwise, a special dividend may be more beneficial for most shareholders.

Research conducted in Australia indicates that markets generally react the most positively to on-market buybacks, while the reaction to other types of share buybacks is positive but not statistically significant. Also, that abnormal returns earned by resource sector companies announcing share buybacks are generally higher than the abnormal returns earned by companies in the industrial and financial services sectors.

Framework for share buybacks
Questions 3.1, 5.11 and 5.38

If it is accepted that off-market share buybacks result in inequities in the taxation treatment between shareholders, then adjustments to the framework should be considered. The most convenient starting points might be the factors driving the outcome such as the formula for calculating the market value of shares (and the capital/dividend split) and the tender discount rate. Further modelling work and targeted consultation with stakeholders should be considered in order to reach the optimal outcome for each of these.

Following are observations with respect to calculating the market value of shares in buybacks for listed companies. Of relevance to this issue is the ATO's taxation determination TD 2004/22 which has the effect of reducing the capital losses available to shareholders on share buybacks. The intention seems to be to address the practice of companies offering shareholders a low capital price for their shares, with the balance of the buyback price made up of a fully franked dividend. The consequence is that shareholders have received a tax benefit from the resulting capital loss and from the fully franked dividend, which seems to be particularly attractive to superannuation funds and institutional investors. The difference between the market value and the final tender price will be added to the capital proceeds of the buyback when calculating the capital gain or loss, which has the impact of reducing the tax advantage. The problem is that shareholders can face uncertainty where the buyback price is not determined until the day the buyback closes.

Various studies show that off-market share buybacks benefit superannuation funds and shareholders on low marginal tax rates. Since the tax determination in 2004, off-market share buybacks seem to have reduced benefits for all those participating, especially those on higher marginal tax rates, which means greater benefit for the company and non-participating shareholders, unless there is a higher buyback price to offset the lower tax benefit.

There has been a reasonable amount of criticism of the formula in TD 2004/22 and it should be reconsidered in targeted consultation with stakeholders.