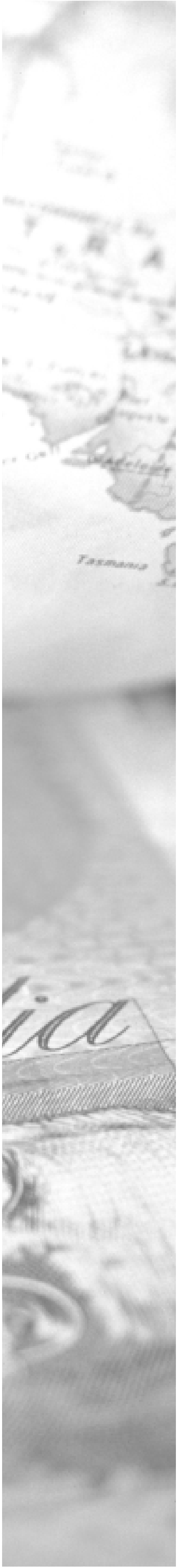
Taxpayers Australia Inc

Review of the tax treatment of off-market share buybacks

Taxpayers
AUSTRALIA INC



Contents

Background on Taxpayers Australia Inc

Taxpayers Australia Inc (formerly known as Australian Taxpayers Association) was established in 1919 and is a not-for-profit organisation committed to educating, informing and representing business and individual taxpayers alike.

We are not affiliated with any political party or any pressure group, and regularly make submissions to the Government on taxation and superannuation issues on behalf of our members and all Australian taxpayers. We are represented on major consultative forums with the Australian Taxation Office.

Taxpayers Australia Inc is also a founding member of the World Taxpayers Associations and the Asia-Pacific Taxpayers Union.

Our aim is to educate and inform taxpayers via our expert publications, online information, media and seminars on tax and superannuation issues and to bring to members the latest and effective tax information.

Our members include tax advisers, accountants, tax agents, financial planners, business people, corporations, investors, students and individual taxpayers, with whom we provide up-to-date information in plain English.

Review of the taxation treatment of off-market share buybacks

Taxpayers Australia Inc welcomes the opportunity to provide a submission on the abovementioned discussion paper.

We do not intend to canvass the arguments either for or against buybacks in our submission. We acknowledge that there are benefits for both low tax paying entities and non-participating, high tax paying shareholders. The arguments for and against are already well documented in your discussion paper. Those groups through their Industry representatives will address these issues in much more detail in any case.

In addition, Taxpayers Australia Inc does not wish to enter the debate about the respective advantages or disadvantages of companies undertaking a buyback as opposed to other mechanisms which may be used to distribute excess cash to shareholders.

Our submission would like to focus on Government's policy surrounding dividend and capital streaming. The current policy allows dividend and capital streaming to occur when off-market buybacks are undertaken which is contrary to legislative policy which discourages such behaviour through the application of various anti-avoidance provisions (s.45A and B, s.177EA ITAA 1936, s.204-30 ITAA 1997).

In question therefore is why are buybacks given preferential treatment with respect to streaming? The anti-avoidance streaming provisions have, in effect, been circumvented as companies do not have other mechanisms to stream dividends to targeted shareholders.

When you sit back and analyse buybacks, it is clearly apparent that off-market buy backs are mostly attractive to low tax paying taxpayers.

The issue of streaming becomes highly relevant in buybacks. Franking credits are essentially being streamed from high marginal tax rate resident shareholders to lower tax rate resident shareholders. It is acknowledged that the ATO does not debit a company's franking account to include any avoided wastage of franking credits occasioned by streaming from high marginal tax rate shareholders to lower rate resident shareholders. It would be practically impossible for companies to calculate how much resident to resident streaming of dividends was actually taking place because they do not have details of particular classes of shareholders who have participated in each buyback.

At present, provided the level of the discount at which the shares are bought back at is no more than 14%, the Commissioner of Taxation does not impose a franking debit on the company's franking account for resident-to-resident streaming.

Even at this maximum level of discount, buybacks are highly attractive to superannuation funds, charities and deductible gift recipients due to the refunding of imputation credits.

Treasury has made estimates of the cost to revenue for resident-to-resident streaming. The cost to revenue was estimated to be $551m in the 2004/05 year and $452m in 2005/06. These figures represent the effect of channelling franking credits to low tax paying entities as opposed to a normal equal distribution across all shareholders (assuming no behavioural changes).

Buybacks facilitate the distribution of franking credits to those shareholders who are able to make the greatest use of them. Off-market buybacks avoid the wastage of franking credits that would otherwise typically occur under equal distribution patterns. The above estimate by Treasury attempts to quantify the difference between the tax actually payable and the tax that would be payable had the franking credits been distributed among all shareholders.

The above estimates do not take into account any debit to the franking account of companies associated with streaming of franking credits from non-resident to resident shareholders. The Commissioner of Taxation does impose a franking debit on companies undertaking buybacks for non-resident-to-resident streaming, but as stated above, there is no penalty debit for resident-to-resident streaming so long as the level of discount does not exceed 14%.

To summarise, we are of the opinion that dividend streaming of franking credits to select shareholders is inconsistent with the general principles that have been established to ensure that tax paid on behalf of shareholders is to be shared equally amongst all shareholders in proportion to their shareholdings. The argument that the buyback is available to all shareholders to participate in becomes irrelevant as a buyback is only attractive to a select class of shareholders. Under the present treatment of buybacks, dividend streaming becomes permissible. This is clearly contrary to the policy underlying the imputation system and the anti-avoidance rules which seek to prevent streaming arrangements. In addition, there is a cost to the community as buybacks reduce the overall revenue raised from companies and their shareholders. The broader tax paying community is the loser as they, in effect, subsidise the refunding of franking credits from high tax paying entities to low tax paying entities.

If you would like to discuss any aspect of this submission please contact the writer on 03 8851 4501.

Tony Greco
CEO
Taxpayers Australia Inc