

TREASURY DISCUSSION PAPER

TAXATION TREATMENT OF OFF-MARKET SHARE BUYBACKS

NOTE TO PARTICIPANTS

This paper is a guide as to how the broad principles recommended by the Board of Taxation might operate.

INTRODUCTION

1. In 2007 the former government asked the Board of Taxation to undertake a review of the taxation treatment of off-market share buybacks. The Board handed its report to the Government on 2 June 2008. A copy of the report is available on the Board of Taxation website (www.taxboard.gov.au).
2. On 12 May 2009 the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, announced that the Government will implement the six recommendations made by the Board of Taxation to improve the taxation framework for off-market share buybacks.

PURPOSE

3. This discussion paper forms the basis for consultation on the design of this proposal and sets out the way it may be implemented. The purpose of the discussion paper is to provide interested parties with an opportunity to comment on the proposal's design.

BACKGROUND

Operation of the existing law

4. The taxation rules dealing with share buybacks are primarily contained in Division 16K of Part III of the *Income Tax Assessment Act 1936* (the ITAA 1936).
5. Division 16K applies where a company buys a share (or a non-share equity interest) in itself from a shareholder and cancels the share. If the share is listed on a stock exchange and the purchase is made in the ordinary course of business of that stock exchange, the buyback will be an on-market purchase. All other buybacks are treated as off-market purchases for taxation purposes.

6. There are no income tax or capital gains tax (CGT) consequences for the company that carries out the buyback (section 159GZZZN). However, a company may be required to debit its franking account balance in respect of an on market or off-market share buyback.
7. The purchase price paid by the company to the shareholder is the amount of money and/or the market value of any property the shareholder receives as consideration for the buyback (section 159GZZM).

On-market share buybacks

8. In an on-market share buyback, no part of the purchase price is taken to be a dividend in the hands of the seller (section 159GZZR). The purchase price forms the consideration or capital proceeds for the purposes of determining the seller's liability to CGT.

Off-market share buybacks

9. In contrast, the purchase price paid to a shareholder who participates in an off-market share buyback is generally divided into a dividend component and a capital component.
10. The dividend component is the difference between the purchase price paid by the company for a share and that part of the purchase price which is debited against the company's share capital account (section 159GZZP).
11. As a general rule, this dividend is a frankable distribution and the company may allocate franking credits to it. However, to prevent a company paying a higher franked dividend than would otherwise be possible, it is not frankable to the extent that the purchase price exceeds 'what would be the market value of the shares at the time of the buyback if the buyback did not take place and was never proposed to take place' (paragraph 202-45(c) of the *Income Tax Assessment Act 1997* (the ITAA 1997)).
12. The capital component is that part of the purchase price which is debited against the company's share capital account. While the capital component is nominated by the company, it needs to be determined using a methodology acceptable to the Australian Tax Office (ATO) in order to avoid the application of various anti-avoidance rules.
13. In particular, where the purchase price is less than the amount that would have been the market value of the share at the time of the buyback 'if the buyback did not occur and was never proposed to occur', the consideration by a shareholder is adjusted. The adjustment is called the market value uplift rule (subsection 159GZZQ(2)) and has the practical effect of increasing the capital component to the market value.
14. The market value uplift rule requires the market value of a share to be calculated on the premise that the buyback was never announced and never took place. The methodology adopted by the ATO for this calculation is outlined in Taxation Determination TD 2004/22. It is based on the volume weighted average price (VWAP) of the company's share on the ASX over the last five trading days before the announcement of the buyback, adjusted for the percentage change in the S&P/ASX 200 Index (or another approved index) from the commencement of trading on the first announcement date to the close of trading on the day the buyback closes.

15. The market value uplift rule has its main application in off-market share buybacks where listed companies seek to buyback their shares at a discount to their prevailing ASX price. The ATO allows a maximum discount cap of 14 per cent calculated by reference to the volume weighted average price of a share over the five trading days up to and including the closing date of a buyback tender period. The level of discount is a relevant consideration in the exercise of the Commissioner's discretion in the application of the anti-avoidance provisions.

Anti-avoidance provisions

16. Specific anti-avoidance provisions target particular arrangements on both the dividend and capital sides, such as franking credit trading and streaming schemes. The anti-avoidance provisions may result in shareholders being denied franking credit tax offsets, penalty debits arising in companies' franking accounts or capital benefits being treated as unfranked dividends.
17. The most important anti-avoidance rules in the context of share buybacks are:
- the qualified person rule (former Part IIIAA of the ITAA 1936);
 - the anti-dividend streaming rule (section 204-30 of the ITAA 1997);
 - the capital benefit streaming and substitution rules (sections 45A and 45B of the ITAA 1936); and
 - the general anti-avoidance provision for franking credit trading (section 177EA of the ITAA 1936).
18. The anti-avoidance provisions in paragraph 177EA(5)(a) of the ITAA 1936 have been used by the Tax Office to determine a debit to the franking account of the company undertaking the off-market share buyback for the imputation credits in respect of non-resident shareholders.
19. Further details of the operation of these integrity rules in the context of off-market share buybacks are contained in a Tax Office Practice Statement Law Administration (PS LA 2007/9).

The Board's recommendations

20. The Board's recommendations can be summarised as follows. These recommendations are explained in more detail in the Board's final report to the Treasurer.

Recommendation 1: Cap on the level of discount

The Board recommends that there should be no cap on the level of the discount to an Australian securities exchange value of shares under off-market share buybacks conducted by listed companies.

Recommendation 2: Non-resident to resident streaming

The Board recommends that:

- there should continue to be a debit to the franking account of the company to reflect the intended wastage of franking credits in the hands of non-resident shareholders; and
- there should be a specific provision dealing with this issue in the context of off-market share buybacks rather than relying on the general streaming and integrity provisions. That provision should include the formula for calculation of the debit to the franking account. Franking credits will continue to be available to shareholders notwithstanding this debit to the franking account.

Recommendation 3: Notional losses

The Board recommends that:

- notional losses should be denied to all shareholders who participate in off-market share buybacks conducted by listed companies. The market value uplift rule in subsection 159GZZZQ(2) of the ITAA 1936 should not apply to off-market share buybacks conducted by listed companies; and
- notional losses should continue to be allowed for shareholders who participate in off-market share buybacks conducted by unlisted companies. The market value uplift rule in subsection 159GZZZQ(2) of the ITAA 1936 will continue to apply to off-market share buybacks conducted by unlisted companies.

Recommendation 4: Greater certainty for listed companies

The Board recommends:

- legislative provisions be introduced that:
 - outline the methodology for the capital/dividend split. Average capital per share should be specified as the general method to be used by companies, with a discretion available to the Commissioner of Taxation to allow companies to apply another methodology such as the slice method or the embedded value method when appropriate to their particular circumstances. The ATO should provide guidance on the circumstances in which these other methodologies may be appropriate;
 - specify an extension of time for listed companies conducting an off-market share buyback to provide a distribution statement;
 - confirm that sections 45A and 45B and paragraph 177EA(5)(b) of the ITAA 1936, and section 204-30 of the ITAA 1997, will not be applied to tender style off-market share buybacks conducted by listed companies where average capital per share is used to determine the capital/dividend split; and

- taxation rulings be issued that:
 - outline the appropriate buyback timetable; and
 - outline the application of the 45 day rule, including how LIFO (last in first out) applies in relation to off-market share buybacks conducted by listed companies.

Recommendation 5: Unlisted companies

The Board recommends the off-market share buyback provisions should generally apply in the same way to listed and unlisted companies, subject to the following modifications:

- sections 45A and 45B and paragraph 177EA(5)(b) of the ITAA 1936, and section 204-30 of the ITAA 1997, will continue to apply to off-market share buybacks conducted by unlisted companies; and
- the ATO should continue to provide guidance on market valuation for unlisted companies.

Recommendation 6: Include buyback provisions in the ITAA 1997

The Board recommends that in amending any existing provisions that apply to off-market share buybacks, consideration be given to moving the provisions currently in the ITAA 1936 to the ITAA 1997.

POLICY DESIGN OF THE PROPOSAL

21. Under the proposal, the primary taxation consequences of share buybacks contained in Division 16K of Part III of the ITAA 1936 will be transferred to the ITAA 1997. [Recommendation 6]
22. Modifications will be made to implement the recommendations of the Board of Taxation. This discussion paper outlines the proposed approach for implementing those modifications.

Some key terms

23. Where a company buys a share (as defined in subsection 995-1(1) of the ITAA 1997) or a non-share equity interest (as defined in subsection 995-1(1)) in itself from a member or equity holder in a company, then:
 - the purchase is a *buyback*;
 - the member or equity holder is the *seller*.
24. If the share or non-share equity interest is listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-1(1) of the ITAA 1997) and the purchase is made in the ordinary course of trading on that stock exchange, the purchase is an *on-market buyback*. Otherwise, the purchase is an *off-market buyback*.

25. For these purposes, a buyback is not made in the ordinary course of trading on a stock exchange in Australia if, when reported to the stock exchange, the transaction under which the buyback is made is, under the stock exchange rules, described as *special*.
26. The *purchase price* in respect of a buyback of a share or non-share equity interest is:
- the amount of money that the seller receives, or is entitled to receive, as a result of the buyback;
 - the market value, at the time of the buyback, of any property (other than money) that the seller receives, or is entitled to receive, as a result of the buyback; or
 - the amount of money and any property the seller receives, or is entitled to receive as a result of the buyback.

Tax consequences for a company that buys back shares

27. If a company buys back a share or non-share equity interest, then the buyback, and any subsequent cancellation of the share or interest, are disregarded for the purposes of:
- determining whether an amount is included in the assessable income, or is an allowable deduction, of the company; and
 - determining whether the company makes a capital gain or capital loss.

Part of the purchase price under an off-market purchase is taken to be a dividend

28. Where a buy back of a share or non-share equity interest by a company is an off-market purchase, part of the purchase price may be taken to be a dividend that is paid by the company.
29. The dividend component (if any) of the purchase price in respect of the buy back of the share or non-share equity interest is the purchase price reduced by the capital component of the purchase price.
30. The capital component of the purchase price in respect of the buyback of the share or non-share equity interest is the part (if any) of the purchase price in respect of the buyback of the share or interest which is debited against amounts standing to the credit of:
- if the membership interest is a share that is bought back – the company's share capital account; or
 - if the membership interest is a non-share equity interest that is bought back – the company's share capital account or non-share capital account.

31. However, the capital component of the purchase price in respect of the buyback of the share or non-share equity interest must not exceed:
- the average capital per share; or
 - the amount worked out under an alternative methodology that is approved by the Commissioner of Taxation.
32. The average capital per share is worked out using the formula:

$$\frac{\text{Amount of ordinary issued capital}}{\text{Number of ordinary membership interests on issue}}$$

Where:

- Amount of ordinary issued capital is the sum of the amounts held in the company's share capital account (as defined in section 975-300) and its non-share capital account (as defined in section 164-10).
- The term 'ordinary membership interests of a company' is defined in section 960-140 to mean the ordinary shares of the company.
- The term 'on issue' is defined in subsection 995-(1).

[Recommendation 4]

33. The dividend component is taken to be paid by the company out of profits derived by the company to the seller as a shareholder in the company, on the day the buyback occurs. This will ensure that the amount that is taken to be a dividend is included in the assessable income of shareholders under section 44 of the ITAA 1936.
34. If the dividend is included to any extent in the seller's assessable income of any year of income, section 118-20 of the ITAA 1997 (which operates to reduce a capital gain by any amount that is otherwise assessable in respect of a CGT event) does not apply to reduce a capital gain arising from an off-market share buyback by the amount of the deemed dividend.

Consideration in respect of an off-market purchase

35. Where a buyback of a share or non-share equity interest is an off-market purchase the seller will be taken to receive, as consideration in respect of the sale of a share or interest, an amount equal to the purchase price in respect of the buyback for the purposes of determining whether:
- an amount is included in the assessable income of the seller (other than as a capital gain) in respect of the buyback;
 - an amount is allowable as a deduction to the seller in respect of the buyback; or
 - the seller makes a capital gain or capital loss in respect of the buyback.

[Recommendation 3]

Adjustments to the deemed consideration in respect of an off-market purchase conducted by a listed company

36. Where the interests of the company that buys back the shares or non-share equity interests are listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-(1)), the amount of consideration that the seller is taken to receive in respect of the sale of the share or interest will be reduced if:
- an amount is included in the assessable income of the seller (other than as a capital gain or as a dividend) in respect of the buyback; or
 - the seller makes a capital gain in respect of the buyback.
37. In these circumstances, the assessable amount or the capital gain will be reduced by the dividend component of the purchase price, but not beyond nil.

[Recommendation 3]

Adjustments to the deemed consideration in respect of an off-market purchase conducted by an unlisted company

38. Where the interests of the company that buys back the shares or non-share equity interests are not listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-(1)), the deemed consideration may be:
- increased to the market value of the shares or non-share equity interests; and / or
 - reduced by the dividend component of the purchase price.

Consideration increased to market value

39. Where the interests of the company that buys back the share or non-share equity interest are not listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-(1)), the amount of consideration that the seller is taken to receive in respect of the sale of the share or interest will be increased to the market value if the purchase price in respect of the buyback is less than the amount that would be the market value of the share or interest at the time of the buyback assuming that the buyback did not occur and was never proposed to occur. [Recommendation 3]

Consideration reduced by dividend component

40. Where the interests of the company that buys back the share or non-share equity interest are not listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-(1)), the amount of consideration that the seller is taken to receive in respect of the sale of the share or interest (increased to market value if necessary) will be reduced by the reduction amount.
41. The reduction amount is the part of the purchase price in respect of the buyback that is taken to be a dividend that is:
- included in the seller's assessable income of any year of income (disregarding section 128D of the ITAA 1936 and section 802-15 of the ITAA 1997); or
 - an 'eligible non capital amount'.

42. An amount that is taken to be a dividend is an 'eligible non capital amount' to the extent that it is not debited against a share capital account or an asset revaluation reserve. For these purposes, an amount of the purchase price that is taken to be a dividend is taken to have been debited against the account or reserves against which the purchase price was debited, and to the same extent.
43. However, the reduction amount is reduced by the 'offsetable amount' if the seller is a corporate tax entity that is entitled to a tax offset for franking credits in respect of the amount that is taken to be a dividend where:
- the seller incurs a capital loss, or an increased capital loss, in respect of the buyback;
 - the seller incurs a tax loss, or an increased tax loss, in respect of the buyback; or
 - the seller can deduct a greater amount, in any year of income, in respect of the issue or acquisition of the share.
44. If the seller is entitled to a tax offset for franking credits attached to the dividend, the dividend consists of an offsetable amount equal to the amount worked out using the formula:

$$\frac{\text{Amount of tax offset}}{\text{Corporate tax rate}}$$

[Recommendation 3]

Dividend component unfrankable in certain circumstances

45. Where the interests of the company that buys back shares are not listed for quotation in the official list of an approved stock exchange (as defined in subsection 995-(1)) and the purchase price in respect of the buyback is more than the market value of the share at the time of the buyback, that part of the dividend component of the buyback price which is attributable to the excess over the share's market value cannot be franked (paragraph 202-45(c)).

Distribution statement

46. An entity that makes a frankable distribution must give the recipient a distribution statement (subsection 202-75(1)). Generally, the statement must be given on or before the day on which the distribution is made (subsection 202-75(2)).
47. Subsection 202-75(2) should be modified to allow an extension of time for a company to give the recipient a distribution statement if:
- the interests of the company that makes the frankable distribution are listed for quotation in the official list of an approved stock exchange (as defined in subsection 995 -(1)); and
 - the frankable distribution is the dividend component of the purchase price in respect of the buy back of a membership interest under an off-market share buyback.

48. In these circumstances, the time for giving the distribution statement should be extended until 7 days after the distribution is made.

[Recommendation 4]

Non-resident to resident streaming

49. The table in section 205-30 sets out when a debit arises in the franking account of an entity and the amount of the debit. It is proposed to amend that table to specify that a franking debit arises if there is an off-market share buyback by a company of a membership interest in the company.

50. The amount of the franking debit will be worked out applying the following formula:

$$\left(\begin{array}{c} \text{Number of shares} \\ \text{brought back} \end{array} \right) \times \left(\begin{array}{c} \text{Franking credit} \\ \text{attached to} \\ \text{each share} \end{array} \right) \times \left(\frac{\begin{array}{c} \text{Number of shares} \\ \text{held by non-resident} \\ \text{shareholders} \end{array}}{\begin{array}{c} \text{Number of shares} \\ \text{held by all shareholders} \end{array}} \right) \times \left(\frac{\begin{array}{c} \text{Dividend} \\ \text{withholding} \\ \text{tax rate} \end{array}}{\begin{array}{c} \text{Company tax} \\ \text{rate} \end{array}} \right)$$

51. The franking debit will arise on the day on which the interest is purchased.

[Recommendation 2]

Certain integrity rules will not apply

52. Where the interests in a company are listed for quotation in the official list of an approved stock exchange (as defined in subsection 995 1(1)) and the capital component of the purchase price in respect of the buyback of the share is the average capital per share, the Commissioner will not be able to make a determination under:

- section 45A of the ITAA 1936 – as a result, the capital streaming rules will not apply to the distribution;
- section 45B of the ITAA 1936 – as a result, the dividend substitution rules will not apply to distribution;
- paragraph 177EA(5)(b) of the ITAA 1936 – as a result, the anti-franking credit trading rules will not apply to the distribution; and
- section 204-30 of the ITAA 1997 – as a result, the anti-dividend streaming rules will not apply to the distribution.

[Recommendations 1, 4 and 5]

APPLICATION DATE

53. The amendments will apply to off-market share buybacks undertaken after the date of Royal Assent of the amending legislation.

SUBMISSIONS

54. We invite interested parties to lodge written submissions on the design of this proposal, including interaction issues with other parts of the tax law, which may be relevant to the design of this proposal. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.
55. The closing date for submissions is 10 July 2009.
56. All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.
57. Written submissions should be addressed to:

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