Ernst & Young
8 Exhibition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
ey.com/au

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Director
Corporate Tax Policy Unit
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

6 December 2022

By email: OMSBBpublicconsultation@treasury.gov.au

EY Submission
Exposure Draft Legislation - Improving the integrity of off-market share buy-backs

Dear Director

Ernst & Young (EY) welcomes the opportunity to respond to the exposure draft law (ED) and draft explanatory material (draft EM) released by Treasury on 17 November 2022 concerning proposals to amend the tax treatment of off-market share buy-backs undertaken by listed public companies *(draft Treasury Laws Amendment (Off-Market Share Buy-Backs) Bill 2022)*.

We understand that the ED proposes to implement the 2022-23 October Federal Budget announcement stated to be intended to "improve the integrity of the tax system by aligning the tax treatment of off-market share buy-backs undertaken by listed public companies with the treatment of on-market share buy-backs." The proposal has retrospective effect from Budget night. We note that there was no prior consultation by the Government on this proposal.

We do not in this submission address issues concerning whether the proposed changes to Division 16K of the Income Tax Assessment Act 1936 (ITAA 1936) are an appropriate policy response by Government. We would be pleased to share our concerns separately in this regard.

However, we note that a considered consultation process to review the taxation treatment of off-market share buy-backs was undertaken by the Board of Taxation in 2007 to which EY provided a detailed submission. We also note the recommendations of the Board of Taxation in its 2008 report, to continue with the Division 16K taxation arrangements but with certain modifications, were accepted by the then Rudd Government in 2009. Those amendments did not ultimately proceed after a change of government (December 2013 announcement by the then Assistant Treasurer).

We have two key concerns with the ED as drafted, which we outline below, and recommend as follows:

- The proposed franking debit for off-market buy-backs undertaken by listed public companies, as set out in new item 9A of the table in subsection 205-30(1) Income Tax Assessment Act 1997 (ITAA 1997) should not proceed
- Subsequent amendments are required to section 45B ITAA 1936 to remove the potential for the ATO to recharacterize some or all of the buyback proceeds as a dividend and for franking debits to arise under section 45C ITAA 1936.

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Further, given the proposed change to remove the ability to treat part of the purchase price of an off-market share buy back as a dividend which can be franked, item 9 of the table in subsection 205-30(1) ITAA 1997 franking debit for an on-market share buy-back should also be removed.

1. New franking debit provision should not proceed

The ED proposes to insert a new franking debit provision for off-market share buy-backs undertaken by listed companies (item 9A of the table in subsection 205-30(1) ITAA 1997), so that the company is required to debit its franking account in respect of the part of the buy-back price not debited to the company's share capital account.

The draft EM states that this rule is intended to improve the integrity of the imputation system and to align the income tax treatment of off-market share buy-backs undertaken by listed public companies with that of on-market share buy-backs. It also states that the rule improves the integrity of the imputation system by ensuring that shareholders continue to benefit from imputation credits proportionate to their shareholding in the company after the buy-back occurs.

We submit that this franking debit rule is not required.

The potential for a franking debit creates unnecessary complexity and uncertainty for companies legitimately undertaking capital management activities.

Given that the proposed changes to the law will preclude any part of the purchase price for the off-market buy-back being treated as a dividend which can be franked dividend, whether a company chooses to utilise retained earnings for a buy-back (including where it may have insufficient share capital for the buy-back) should not adversely impact the company's ability to pay future franked dividends by reducing the franking account. Further, by adopting our recommendation below in relation to legislation that ensures the non-application of section 45B ITAA 1936 to on-market and off-market share buy-backs, the integrity of the imputation system can be maintained without the need for such a complex rule.

2. Section 45B/45C amendments required

We anticipate that as a result of the proposed changes to the tax treatment of off-market share buy-backs, listed public companies would typically only now undertake such a buy-back:

- Only out of share capital
- Where other circumstances mean an on-market buy-back is not feasible.

We submit that where a listed public company undertakes an off-market share buy-back only out of share capital then the policy intent of the changes has been met and there should be no further potential additional adverse tax consequences to the company. This includes in respect of the franking account of the company.

We therefore submit that subsequent amendments be made to sections 45B and 45C of the ITAA 1936 to confirm the provisions cannot apply to an off-market share buyback by a listed company and ensure that a franking debit cannot arise to the listed public company in these circumstances.

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We note that the Commissioner can currently make a determination under subsection 45B(3) of the ITAA 1936 in respect of a scheme where, under the scheme, a person is provided with a capital benefit (such as the distribution of share capital), a taxpayer obtains a tax benefit and, having regard to the relevant circumstances of the scheme, it would be concluded that a person entered into or carried out the scheme for a purpose (not including an incidental purpose) of enabling a taxpayer to obtain a tax benefit.

If the Commissioner makes a determination under subsection 45B(3), subsection 45C(1) of the ITAA 1936 applies to treat the capital benefit as an unfranked dividend for income tax purposes. Further, the Commissioner can impose a debit to the franking account of the company that implemented the scheme if the company had a more than incidental purpose in carrying out the scheme to avoid a franking debit arising (subsection 45C(3) of the ITAA 1936).

If, notwithstanding our submission above, the proposed franking debit under section 205-30 ITAA 1997 proceeds then a listed public company may therefore be penalised with a franking debit whether or not they utilise retained earnings to undertake their off-market buy-back.

The Commissioner accepts that section 45B ITAA 1936 does not apply to on-market share buy-backs, predominantly because the relevant purpose test cannot be satisfied (see ATO Interpretative Decision ATO ID 2003/1094). We agree with the Commissioner, and therefore submit that the tax legislation should expressly state that section 45B ITAA 1936 cannot apply to an on-market share buy-back to the extent that the purchase price is debited against the share capital account of the company.

Given that the Division 16K ITAA 1936 changes are proposed to be an integrity measure for off-market share buy-backs, by ensuring that no part of the purchase price is to be taken to be a dividend, publicly listed company taxpayers will be expected to debit all of the purchase price against the share capital account, as is the case for on-market buy-backs. Therefore, we also submit that section 45B ITAA 1936 should be expressed to also not apply to an off-market share buy-back by a listed public company on the basis that the policy intention is achieved when a company debits all of the purchase price against share capital.

Consequently, there should be no further consequences under the income tax legislation if a listed public company debits the purchase price for any buy-back of its shares, whether it be an on-market purchase or an off-market purchase, against its share capital account. This includes in particular that:

- Section 45B of the ITAA 1936 does not apply
- Section 45C of the ITAA 1936 does not apply
- There be no possibility of any franking debit arising under section 205-30 of the ITAA 1997.

If the policy intent is to align off-market buy-backs with on-market buy-backs, then switching off section 45B ITAA 1936 for both on and off-market share buy-backs of listed public companies in these circumstances will support that policy as well as avoid uncertainty and decrease complexity for companies and their shareholders. It naturally follows that no franking debit should arise under section 205-30 of the ITAA 1997 for a buy-back of any type undertaken by a listed public company.

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Yours sincerely

Ernst & Young