9 December 2022

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

By e-mail: OMSBBpublicconsultation@treasury.gov.au

Submission to the Consultation on Improving the Integrity of Off-Market Share Buy-backs

We appreciate the opportunity to make a submission to the consultation on improving the integrity of off-market share buy-backs.

We are investors in Australian equities, investing ~$9b on behalf of Australian households who are mainly saving for retirement through their superannuation accounts. We invest for the long-term in a broad range of listed Australian companies and we interact with Boards and management of these companies on many different issues, but take a particularly keen interest in capital allocation.

We have reservations about the new proposals, which would change the way an off-market buy-back would be treated. Removing the ability to distribute a part of the buy-back as a franked dividend will, we think, create perverse incentives that currently do not exist. In particular, **there would now be an incentive for Australian companies to invest overseas** so as to create an earnings stream that would be ineligible for franking but would allow the full distribution of franking credits over time. We do not think this is what the Australian Government would wish to encourage.

In the ordinary course of business, companies make profits, pay taxes and make distributions as a fraction of their net profit after tax. For companies with predominantly Australian earnings, they will receive franking credits for the corporate taxes they have paid. The payout ratio (the fraction of net profit after tax paid in dividends) is often less than one because companies would typically like to retain some earnings in order to grow their business. If the payout ratio is such that the distribution is (consistently) less than the total Australian earnings, then franking credits will build up on a company's balance sheet. Importantly, even with the proposed changes, those franking credits have real value in the hands of shareholders.

Because companies have a duty to maximise long-term value for shareholders, they will look to find a way to distribute those excess franking credits. The current preferred mechanism is through an off-market buy-back, which benefits both existing non-selling shareholders (as the company would typically buy back shares at a discount to the current trading price) and selling shareholders (as they receive a part of the proceeds in the form of a franked dividend). It is efficient and keeps a lot of the capital in Australia.

Under the proposed changes, this avenue would not have the same advantages: the discount would not be available as the franking credits would not be distributed as part of the proceeds of the buy-back. We see two viable alternatives for companies to make sure those excess franking credits are distributed in a timely fashion, neither of which are favourable when assessed against the objectives of this rule change:

1. ***Companies increase their payout ratios and fund the difference through a Dividend Reinvestment Plan (DRP)***. This would reduce the franking credit build-up. In fact, companies could eliminate the build-up altogether by matching distributions to Australian earnings, and having an (underwritten, if necessary)

discounted DRP to fund any future growth options. This would come at a cost to shareholders who may nevertheless be happy to bear it given the value of the franking credits. Moreover, it would dramatically reduce the revenue-raising potential of these proposed changes for Government.

2. ***Companies diversify their earnings streams by investing capital overseas***. This would allow companies to match distributions to Australian earnings, and still retain sufficient earnings to grow their businesses. Done well, it would eliminate any franking credit build-up and would not introduce any frictional costs associated with a discounted DRP. However, from a Government revenue perspective and a public policy perspective, we fail to see how this would be a good outcome.

While we applaud the Government's desire to close loopholes and plug leaks in tax revenue, we do not think this proposed rule change is the way to go about it. Does Government really want Australian companies to preferentially invest overseas (relative to the status quo) rather than invest in Australia? We see this outcome as a natural, if not certain, consequence of the proposed rule change.

Yours sincerely,

Suhas Nayak, Ph.D.
Investment Analyst / Portfolio Manager