SUBMISSION: DRAFT TREASURY LAWS AMENDMENT (OFF-MARKET SHARE BUY-BACKS) BILL 2022

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BACKGROUND[2]

Australia's full imputation system of company tax seeks to achieve a single layer of tax at local shareholders' tax rates on local company income. However, double taxation of retained local income of Australian companies can arise via the interaction between Australia's full imputation system of company tax and its general CGT regime. Because of delays inherent in both full imputation and capital gains tax (CGT) design, when company income is retained, the sought-after single layer of tax may only be achieved over time.

Income retained by a company likely increases the company's share price. Retained income that has already been taxed at the company's tax rate can therefore be double taxed when shareholders who held shares prior to the price increase are subject to CGT (or regular income tax) on subsequent sale of their shares.

That double tax may be relieved when the retained income is distributed, share price falls and those shareholders who acquired shares after the shares' initial price increase sell their shares and attract a CGT loss (or regular tax loss).

Off-market share buy-backs, a legitimate commercial activity for companies, say, to re-jig their capital structures, also provide a mechanism to offset double taxation of retained income – a single mechanism which combines the effects of both distribution of income and sale of shares for those participating in the buy-backs.

On-market share buy-backs do not provide a mechanism to offset double taxation of retained company income. Shareholders, who unbeknown to them sell their shares back to their company, are subject to CGT on their sales just like other sellers. The challenge for tax design is to ensure that double tax arising from on-market share buy-backs is still relieved over time.

Overall, both forms of share buy-backs, being legitimate commercial activities, would ideally be neither encouraged nor interfered with by our income tax law – taking into account the inherent delays imposed by our imputation and CGT arrangements on the taxing of current-year company income at shareholders' tax rates.

CHANGES TO TAX TREATMENT OF OFF-MARKET BUY-BACKS IN DRAFT BILL

The draft legislative changes do not seem to have a clear, targeted objective, apart from improving "integrity" and removing what is seen now as an "inappropriate" distinction between off- and on-market share buy-backs.

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[2] See Review of Business Taxation (1), *A Platform for Consultation*, "Building on a strong foundation, The taxation of entities", Discussion Paper 2, Volume II (J Ralph, Chairman), AGPS, Canberra (February, 1999), pp453-458 (Chapter 20 – 'Preventing double taxation of buy-backs, redemptions and liquidations'). Available at: https://webarchive.nla.gov.au/awa/20180316084138/http://rbt.treasury.gov.au/ (via 'Publications' link).

In relation to off-market buy-backs, the reference to integrity in the explanatory material might relate to common claims made over the years; such as, cost to tax revenue, tax avoidance, artificially fabricated treatment, strange CGT outcomes, inequitably advantaging low-tax rate shareholders and streaming of franking credits away from shareholders who decide not to participate in the buy-backs.

Against the broad integrity objective of the draft legislation, the proposed changes seek to align the tax treatment of off-market share buy-backs (or equivalent capital reductions) with that of on-market share buy-backs. That alignment is proposed to be achieved by: ensuring a company's off-market buy-back price matches market price; having no part of the off-market buy-back price treated as a dividend; and, debiting the purchasing company's franking account by the amount of franking credits in the slice of the company being bought back.

HOW IS AN ON-MARKET SHARE BUY-BACK BEST VIEWED?

Off-market buy-backs are best viewed as part liquidations of the companies concerned. The shares bought back are cancelled, along with associated contributed capital (or "capital account"), retained income and franking credits. Non-participating shareholders retain their interest in remaining contributed capital and untaxed and taxed income plus franking credits – so long as the mix of capital, income and franking credits offered in the buy-back truly reflects a proportionate slice of the company being bought back.[3]

Take Jack, on a 47 per cent tax rate, who wants to participate in an up-coming off-market share buy-back of an all-local company. Assume all the company's profits are taxable at 30 per cent and, initially for illustrative purposes, there is no CGT discount.

Before the buy-back, Jack buys a parcel of shares for $100 plus associated contributed capital for each $70 of retained post-tax income in the parcel – even though he will pay $17 extra tax on each $70 of post-tax income when he receives that as franked dividends in the buy-back. At this point, the retained company income has been double taxed: once in the company and again through CGT paid on the retained company income by those local shareholders selling to others before the buy-back.

Jack is prepared to pay $100 above contributed capital for those shares because he will attract a matching $100 capital loss in the buy-back equal to purchase price less contributed capital. On the one hand, Jack faces $47 tax on each $100 of company income (franked dividends plus franking credits) from the buy-back. On the other hand, absent a CGT discount, Jack gets $47 of tax savings from the matching CGT loss because he has capital gains from elsewhere. Jack is then left with a net $30 refund of franking credits, explaining why he would pay $100 for each $70 of franked dividends he will get in the buy-back.

The prior double tax on retained company income has been neatly removed via the buy-back. What is left is the single layer of CGT paid by shareholders previously selling the shares that Jack bought before the buy-back – shareholders who held shares when the retained income was earned.

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[3] See Review of Business Taxation (2), *A Tax System Redefined*, "Overview, recommendations, estimated impacts" (J Ralph, Chairman), AGPS, Canberra (July, 1999), pp 454-455 (Section 12 – 'Distributions'). Available at: https://webarchive.nla.gov.au/awa/20180316084138/http://rbt.treasury.gov.au/

Even if Jack's tax rate were not 47 per cent, he would realise the same net $30 of tax savings in the buy-back. If, for example, Jack had a 15 per cent tax rate, the $30 of net savings per $100 of pre-tax company income would come from a $15 refund of the $30 tax paid by the company and $15 worth of capital loss.[4]

Rather than imposing integrity problems, beyond the sound commercial reasons for it, the off-market buy-back removes double taxation. As noted, double tax would be similarly removed if the company, instead of undertaking the buy-back, distributed all retained income and shareholders like Jack sold their shares to others. Such removal of double tax would also ideally result if, alternatively, the company fully liquidated (rather than part liquidated).

So far no CGT discount has been assumed. The current CGT discount means that the tax savings from Jack's capital loss would be cut in half, disadvantaging him relative to those on lower marginal tax rates. Those on a zero tax rate, for example, would pay no tax on the company income they get from the buy-back and would get no tax savings from the associated CGT loss. Their outcome would always be a net $30 refund, despite the CGT discount.[5]

WHAT ABOUT ON-MARKET BUY-BACKS?

Shareholders who sell shares in their company while the company is undertaking an on-market buy-back do not know whether the buyer of their shares is their own company or just another purchaser in the market. Consequently, all shareholders selling on market attract common CGT (or regular income tax) treatment, regardless of who acquires their shares.

Inevitably, CGT treatment (or regular income tax) is accompanied by the prospect of double taxation of company income. Nevertheless, two possible mechanisms could be applied to address double taxation associated with the shares bought back and cancelled in an on-market buy-back.

The first mechanism is not to cancel the imputation credits associated with the shares bought back. The company has paid participating shareholders for these credits. With the credits not cancelled, double taxation will eventually be relieved when those credits are distributed with untaxed income.[6] At the extreme, those credits would still be held by the company when it is liquidated. Then, on liquidation, those credits should increase franked dividends and decrease measured return of capital – thus, increasing the capital loss attracted by shareholders at that time.[7]

The second mechanism builds on the first and, in addition, allows the company undertaking the buy-back to attract an immediate capital loss equal to the taxed income component of the slice of the

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[4] For diagrammatic presentation of off-market share buy-backs under the same assumptions, together with further discussion, see attached *Share Buy-backs.pdf*, pp 1-9. The 11 pages of *Share buy-backs.pdf* are a copy of pages 8 to 18 of Comic 6 in the Brad series of tax comics, available at: www.kyscope.com.au/Brad.
[5] For more detail, see attached *Share Buy-backs.pdf*, p 8.
[6] For more detail, see attached *Share Buy-backs.pdf*, pp 10-11.
[7] For a case study of off-and on-market share buy-backs, including cash flows of both types of buy-back undertaken by a local company during its five years of operation see W Mayo,*Taxing Investment Income: without affecting worldwide investment decisions*, Kyscope publishing, Canberra (2011), pp 241-257. Available at: www.kyscope.com.au.

company bought back. This would immediately increase the scope for untaxed income in the company to absorb the retained franking credits and be reflected in franked dividends.[8]

In contrast to these two mechanisms, the draft amendments transfer to off-market share buy-backs the current practice with on-market share buy-backs of cancelling imputation credits associated with shares bought back – even though no shareholder has benefited from those credits.

SUGGESTED ALTERNATIVE TAX DESIGN CHANGE

Sound tax design for off-market share buy-backs (design that does not interfere with, or encourage, them) would be furthered by not progressing the draft bill and, instead, instituting administrative change that:

- ensured that the split between contributed capital and retained income (untaxed and taxed with imputation credits) in a buy-back truly represents the slice of the company being liquidated; and
- removed any administrative arrangements that limit the discounting of buy-back price to market price.

For on-market share buy-backs, sound legislative design that recognises the issue of double taxation would see:

- the company undertaking the buy-back retain the franking credits associated with its cancelled shares.

Going further with deeper legislative change, removing the CGT discount would remove the relative advantage given to low-tax rate shareholders in off-market share buy-backs (and provide broader economic improvements).

There is also potential for major legislative improvement – with considerable benefits in terms of productivity, fairness and tax revenue collections – from upgrading our full imputation system to integration of taxable income. Under integration, when taxed company income is retained it is allocated to shareholders, together with franking credits and cost base adjustment to shares to remove double taxation. All current-year taxable company income is then taxed at shareholders' current-year tax rates, consistent with the taxing of investment income of sole traders and trust investors. In the above illustrative example of an off-market buy-back, those selling out to Jack would have previously got refunds or paid extra tax on the company's retained taxed income and Jack's share price pre-buy-back would not include franking credits.

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[8] See Review of Business Taxation (1), op cit, pp 460-462 and Review of Business Taxation (2), op cit, pp456-457.