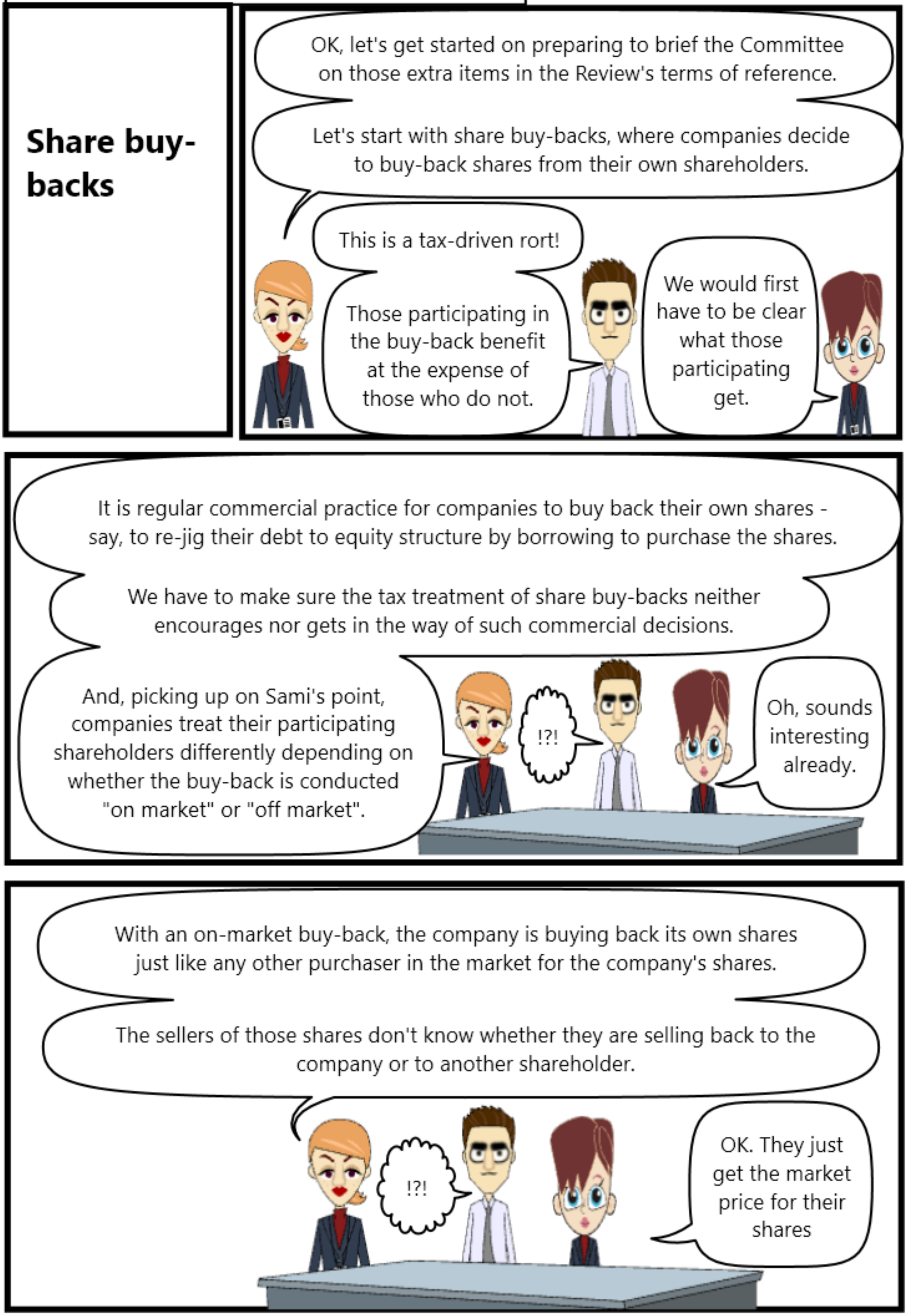
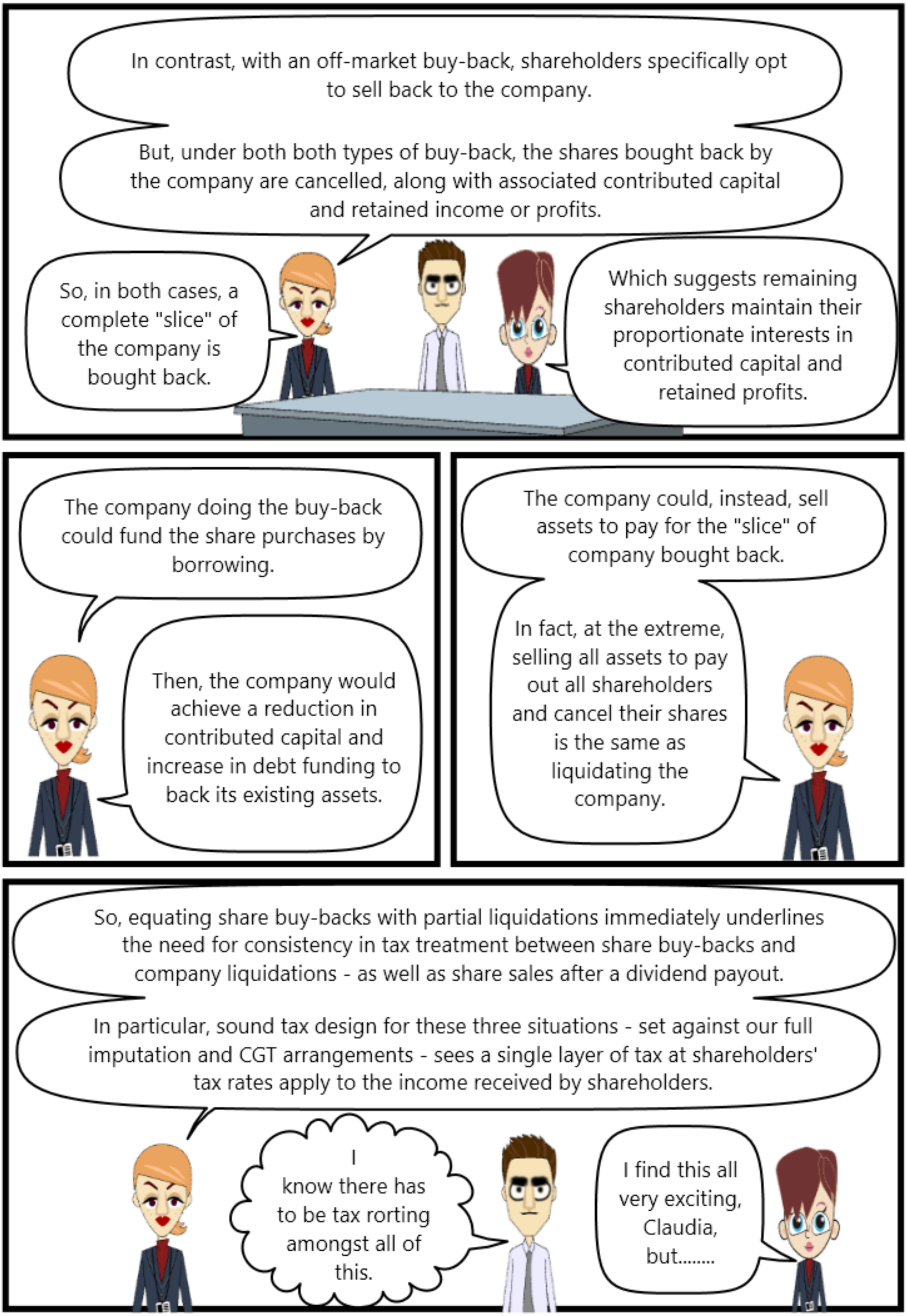
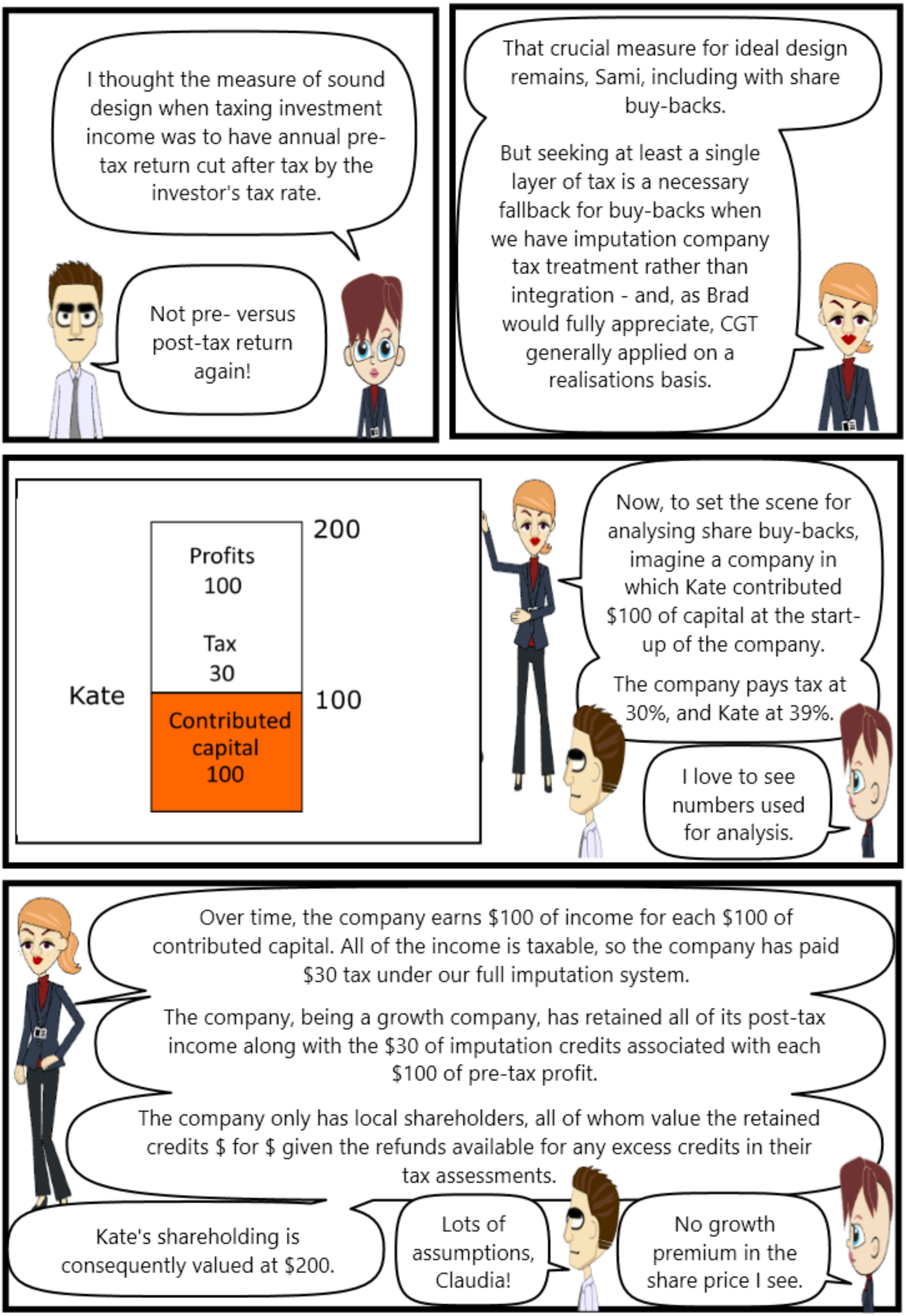
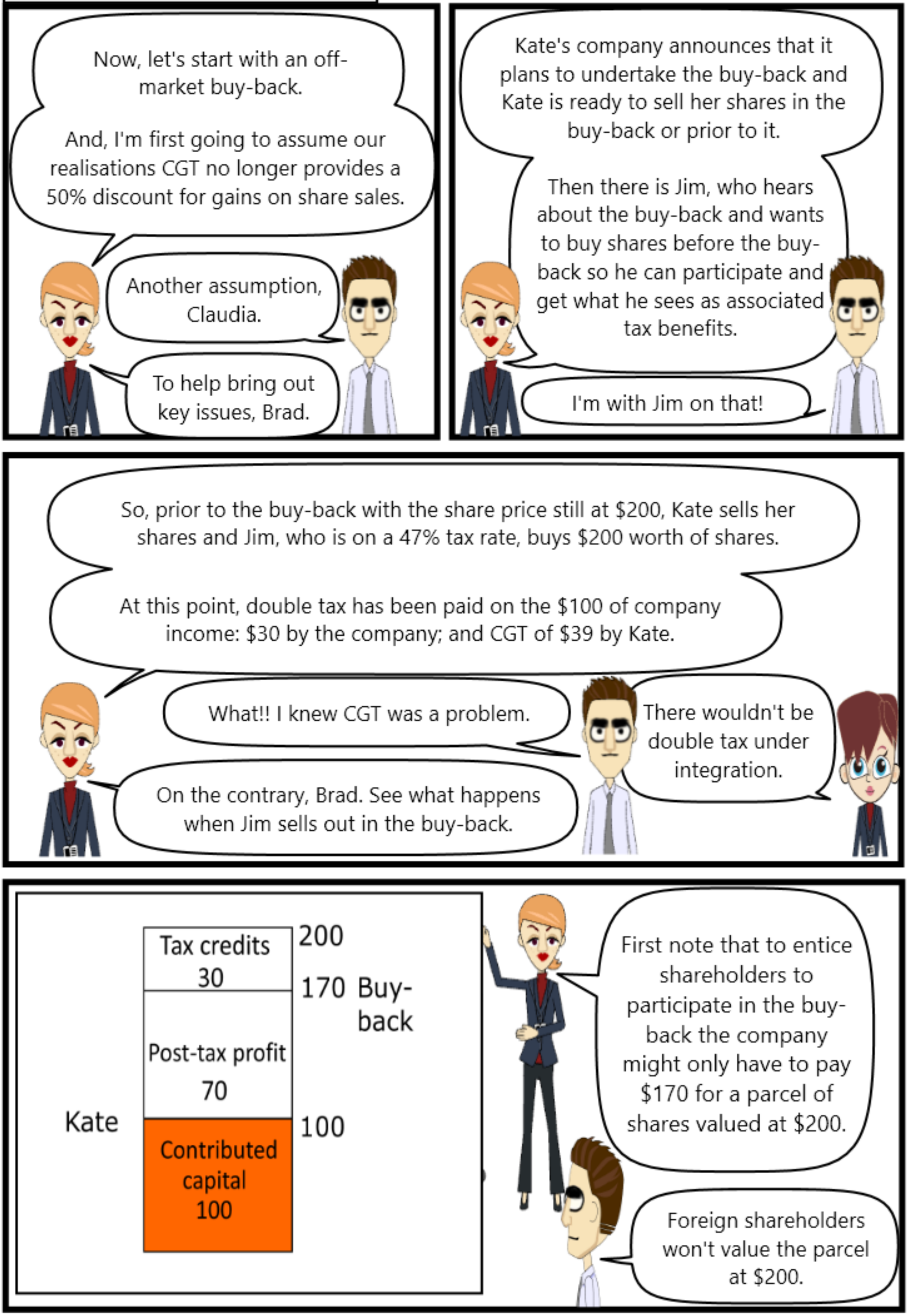
Income tax treatment of share buy-backs

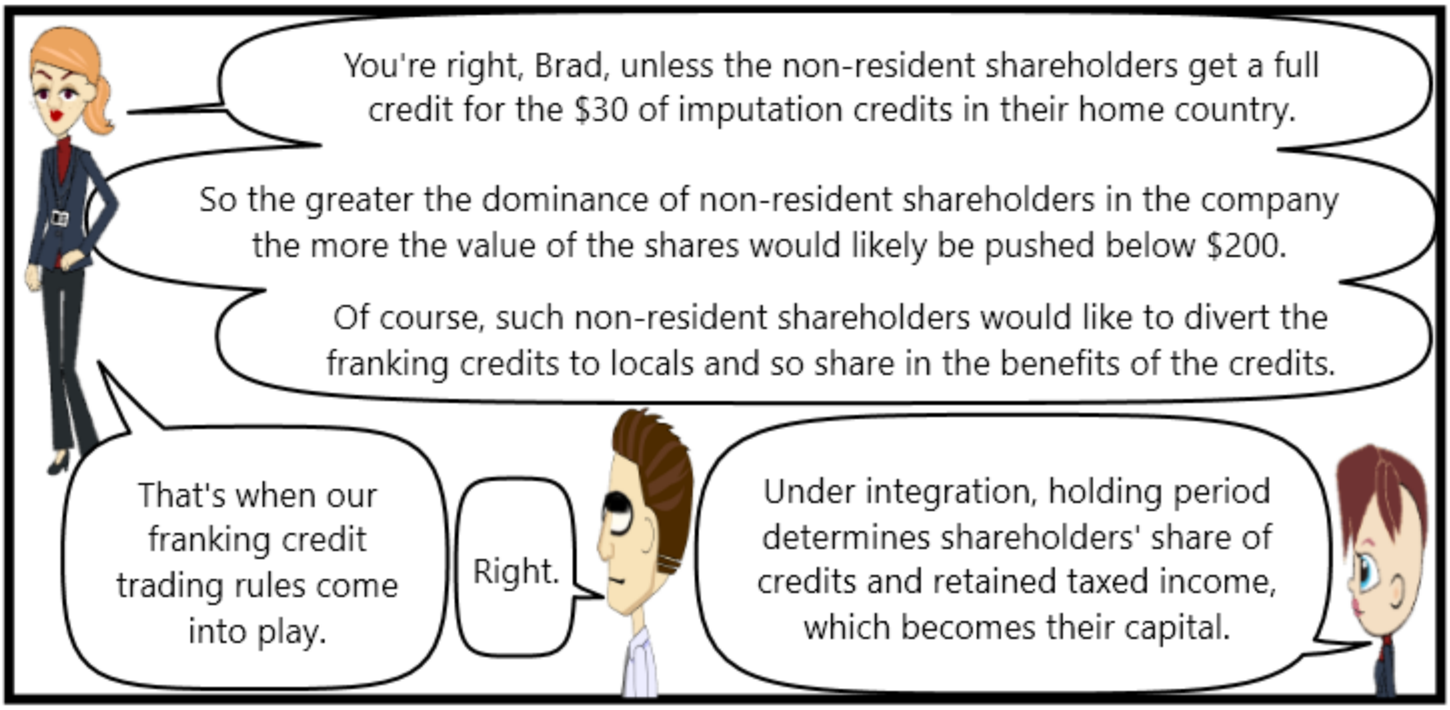


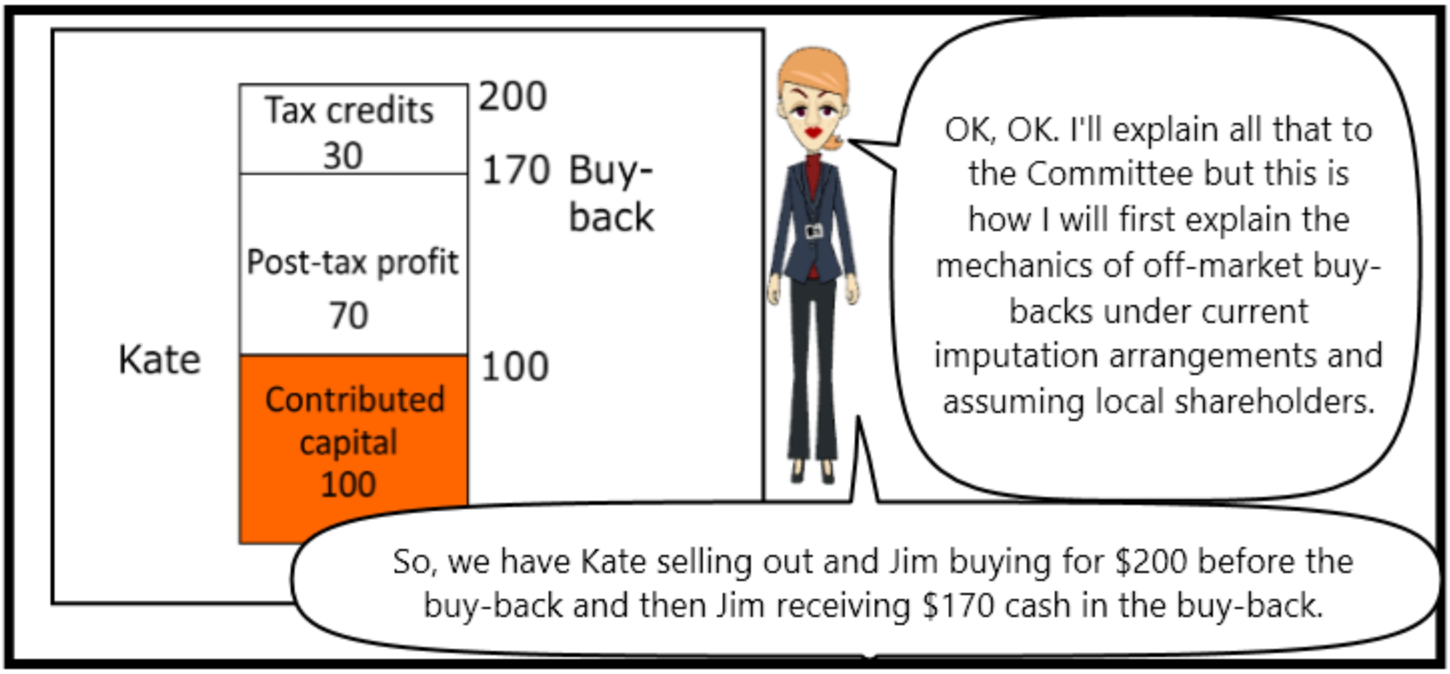

In contrast, with an off-market buy-back, shareholders specifically opt to sell back to the company.
But, under both both types of buy-back, the shares bought back by the company are cancelled, along with associated contributed capital and retained income or profits.
So, in both cases, a complete "slice" of the company is bought back.
Which suggests remaining shareholders maintain their proportionate interests in contributed capital and retained profits.
The company doing the buy-back could fund the share purchases by borrowing.
Then, the company would achieve a reduction in contributed capital and increase in debt funding to back its existing assets.
The company could, instead, sell assets to pay for the "slice" of company bought back.
In fact, at the extreme, selling all assets to pay out all shareholders and cancel their shares is the same as liquidating the company.
So, equating share buy-backs with partial liquidations immediately underlines the need for consistency in tax treatment between share buy-backs and company liquidations - as well as share sales after a dividend payout.
In particular, sound tax design for these three situations - set against our full imputation and CGT arrangements - sees a single layer of tax at shareholders' tax rates apply to the income received by shareholders.
I know there has to be tax rorting amongst all of this.
I find this all very exciting, Claudia, but........

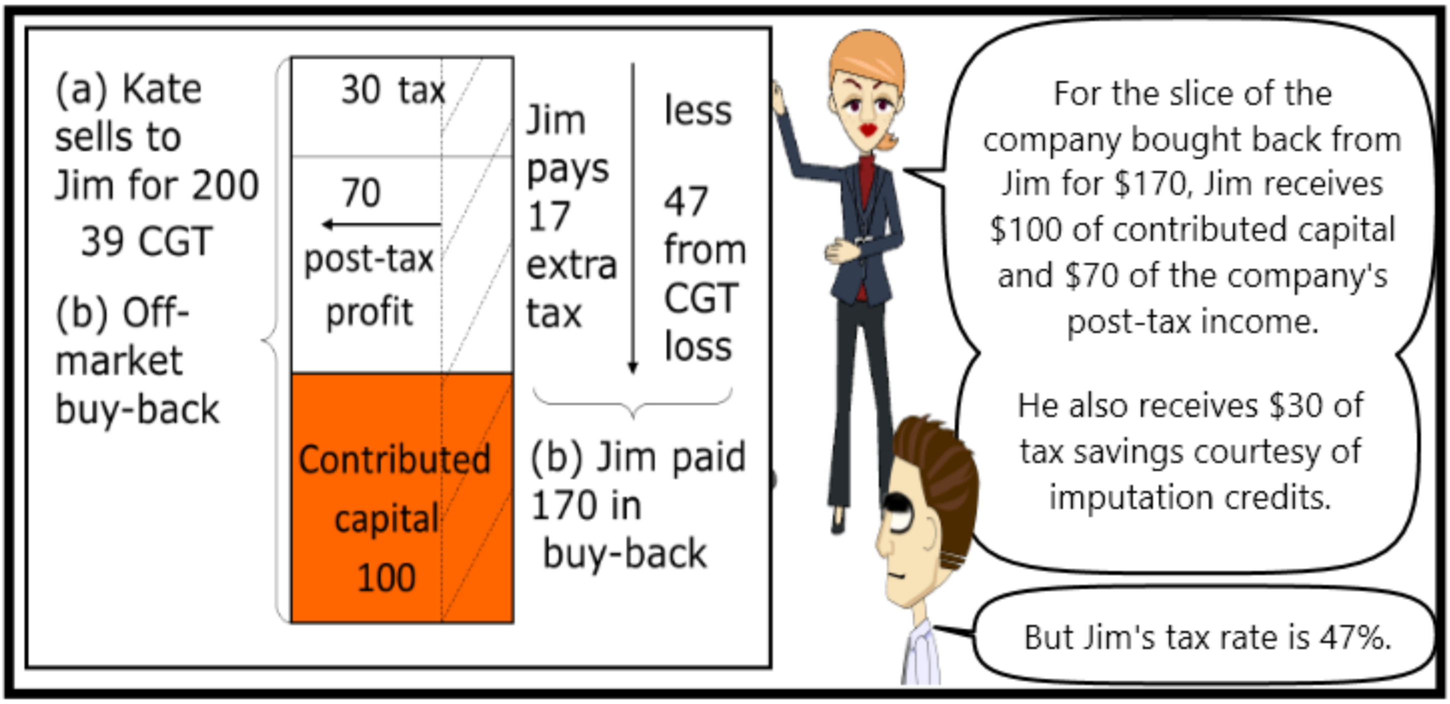

I thought the measure of sound design when taxing investment income was to have annual pre-tax return cut after tax by the investor's tax rate.
Not pre- versus post-tax return again!
That crucial measure for ideal design remains, Sami, including with share buy-backs.
But seeking at least a single layer of tax is a necessary fallback for buy-backs when we have imputation company tax treatment rather than integration - and, as Brad would fully appreciate, CGT generally applied on a realisations basis.
Kate
Profits 100
Tax 30
Contributed capital 100
200
100
Now, to set the scene for analysing share buy-backs, imagine a company in which Kate contributed $100 of capital at the start-up of the company.
The company pays tax at 30%, and Kate at 39%.
I love to see numbers used for analysis.
Over time, the company earns $100 of income for each $100 of contributed capital. All of the income is taxable, so the company has paid $30 tax under our full imputation system.
The company, being a growth company, has retained all of its post-tax income along with the $30 of imputation credits associated with each $100 of pre-tax profit.
The company only has local shareholders, all of whom value the retained credits $ for $ given the refunds available for any excess credits in their tax assessments.
Kate's shareholding is consequently valued at $200.
Lots of assumptions, Claudia!
No growth premium in the share price I see.

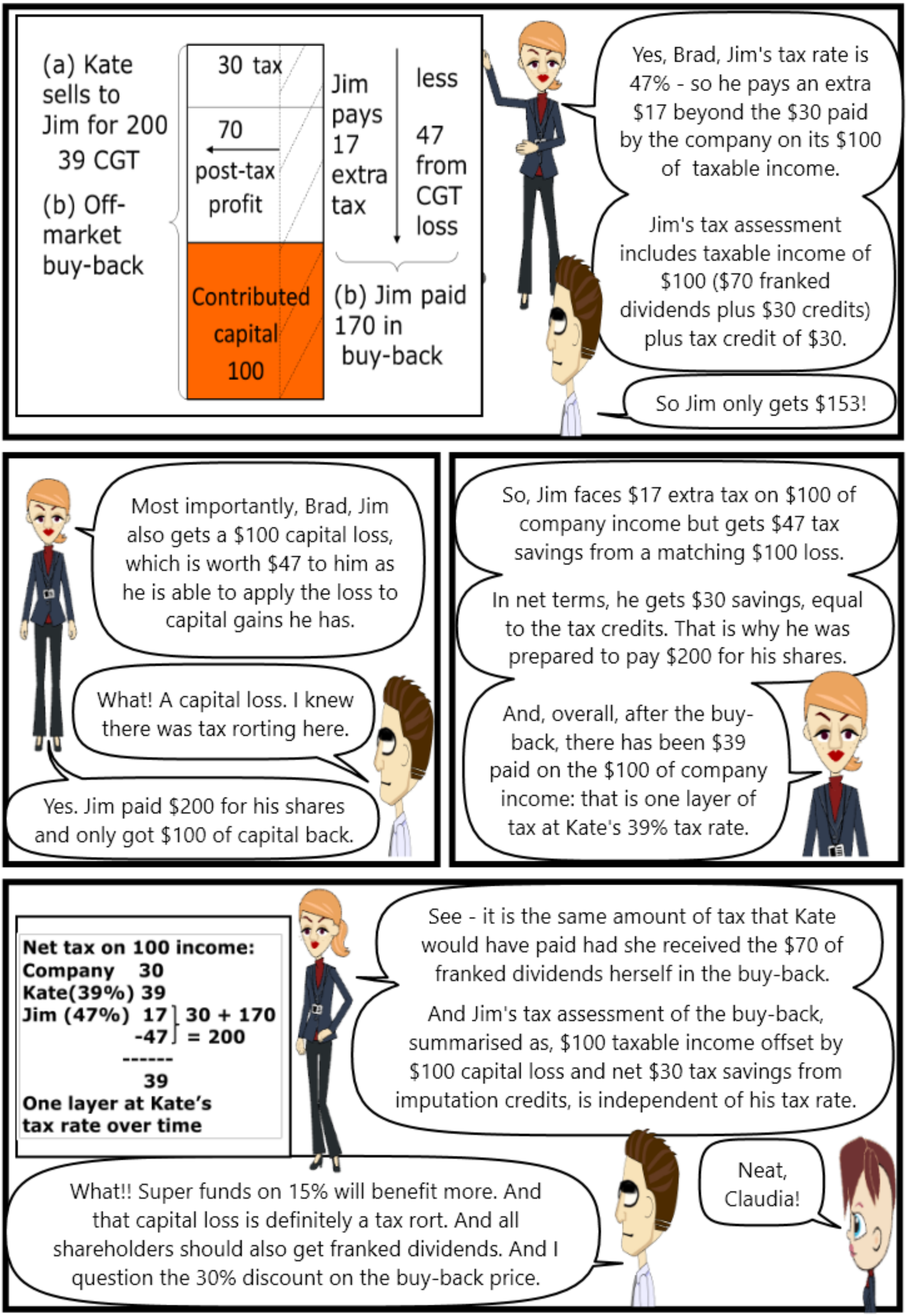
Off-market share buy-back




You're right, Brad, unless the non-resident shareholders get a full credit for the $30 of imputation credits in their home country.
So the greater the dominance of non-resident shareholders in the company the more the value of the shares would likely be pushed below $200.
Of course, such non-resident shareholders would like to divert the franking credits to locals and so share in the benefits of the credits.
That's when our franking credit trading rules come into play.
Right.
Under integration, holding period determines shareholders' share of credits and retained taxed income, which becomes their capital.


Tax credits 30
Post-tax profit 70
Contributed capital 100
200
170 Buy-back
100
Kate
OK, OK. I'll explain all that to the Committee but this is how I will first explain the mechanics of off-market buy-backs under current imputation arrangements and assuming local shareholders.
So, we have Kate selling out and Jim buying for $200 before the buy-back and then Jim receiving $170 cash in the buy-back.


(a) Kate sells to Jim for 200 39 CGT
(b) Off-market buy-back
30 tax
70 post-tax profit
Contributed capital 100
Jim pays 17 extra tax
less 47 from CGT loss
(b) Jim paid 170 in buy-back
For the slice of the company bought back from Jim for $170, Jim receives $100 of contributed capital and $70 of the company's post-tax income.
He also receives $30 of tax savings courtesy of imputation credits.
But Jim's tax rate is 47%.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39 CGT
(b) Off-market buy-back
30 tax
70
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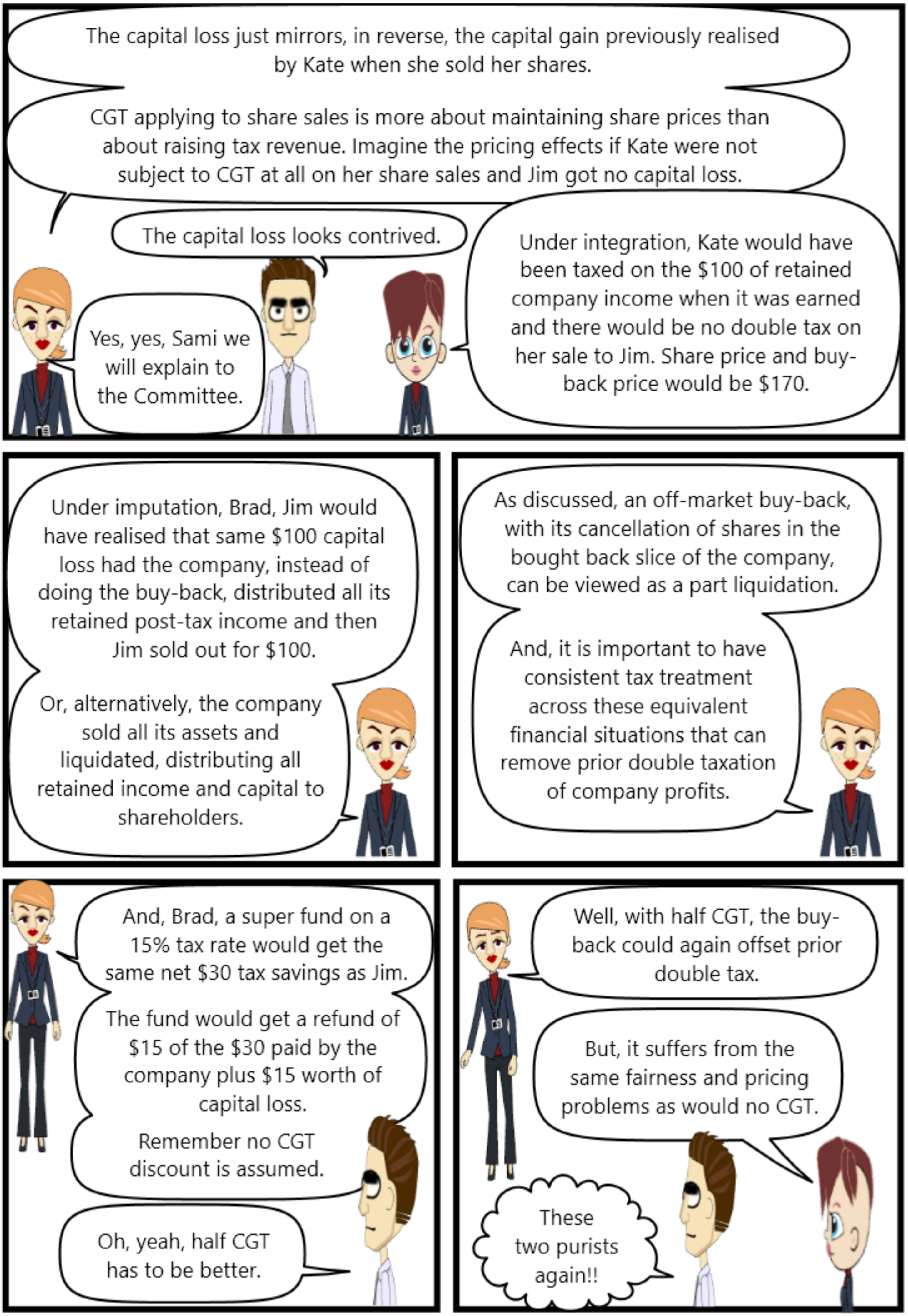
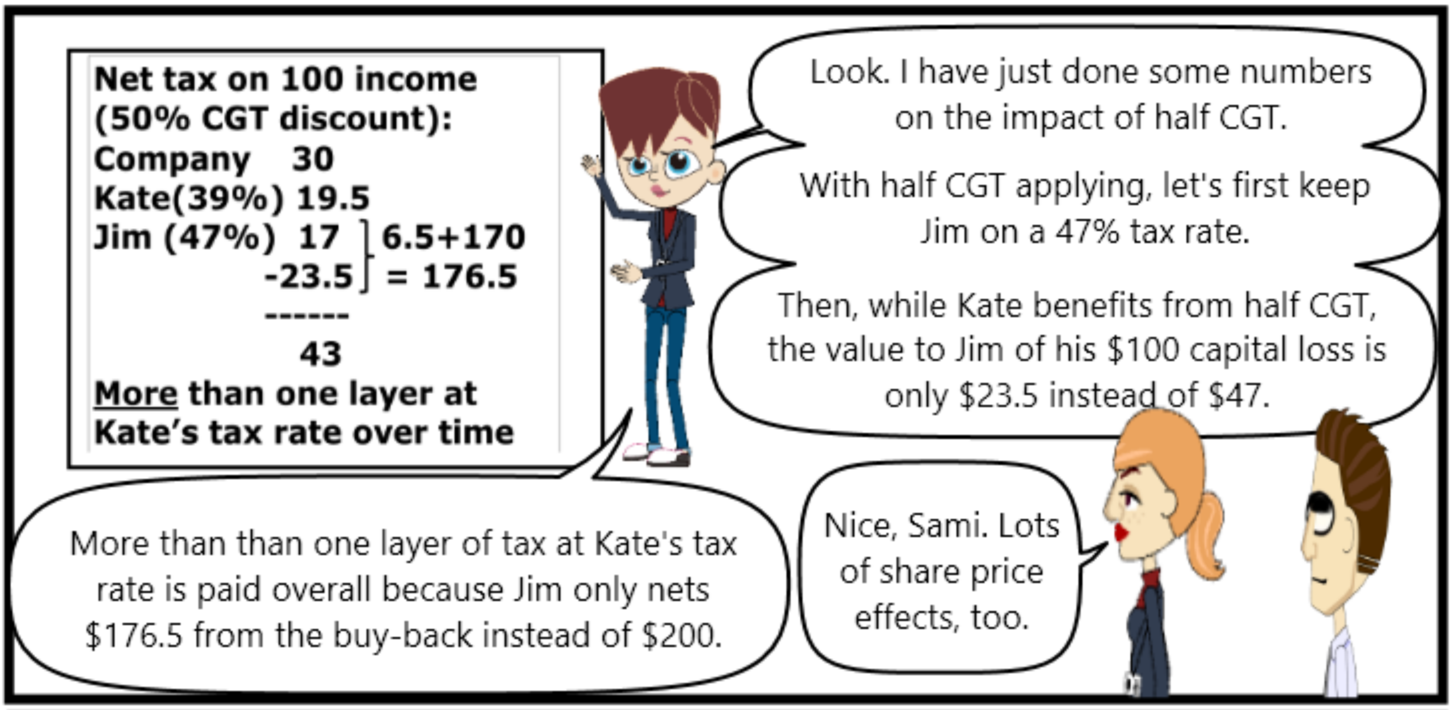
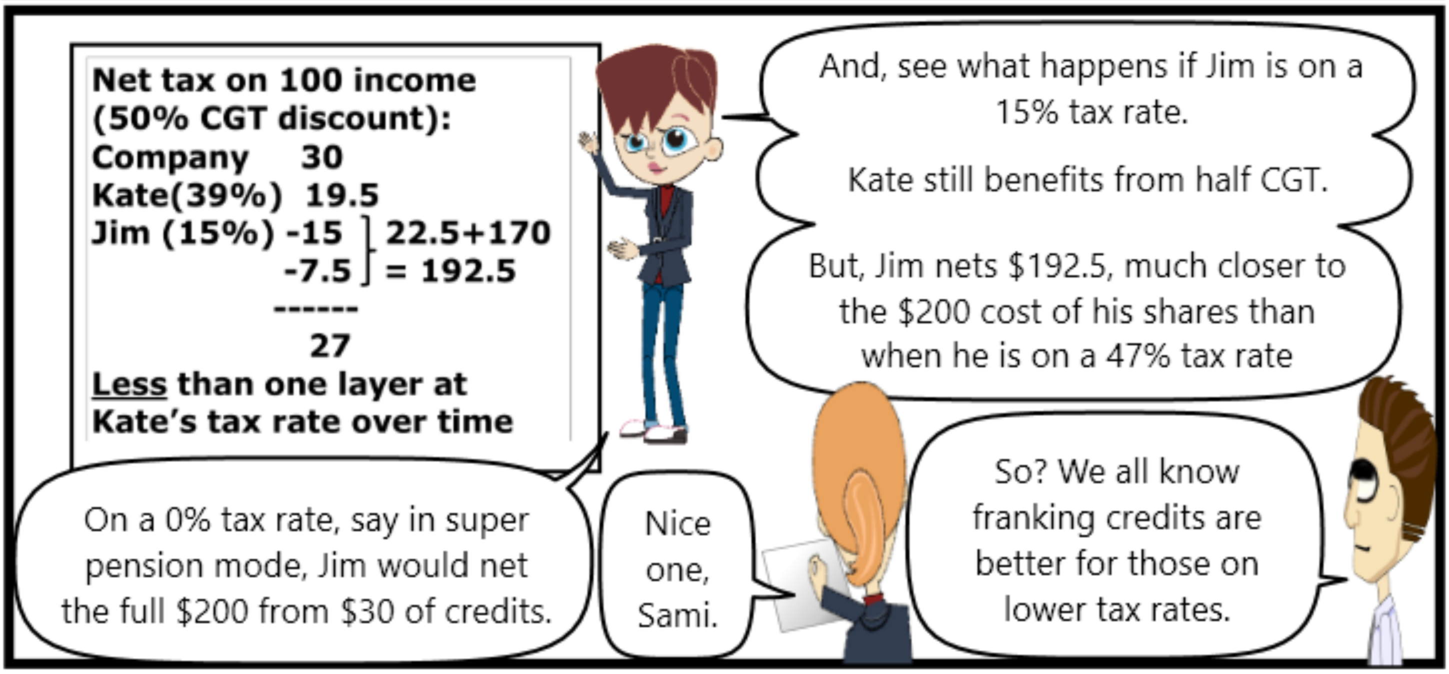
(b) Jim paid 170 in buy-back
Yes, Brad, Jim's tax rate is 47% - so he pays an extra $17 beyond the $30 paid by the company on its $100 of taxable income.
Jim's tax assessment includes taxable income of $100 ($70 franked dividends plus $30 credits) plus tax credit of $30.
So Jim only gets $153!
Most importantly, Brad, Jim also gets a $100 capital loss, which is worth $47 to him as he is able to apply the loss to capital gains he has.
What! A capital loss. I knew there was tax rorting here.
Yes. Jim paid $200 for his shares and only got $100 of capital back.
So, Jim faces $17 extra tax on $100 of company income but gets $47 tax savings from a matching $100 loss.
In net terms, he gets $30 savings, equal to the tax credits. That is why he was prepared to pay $200 for his shares.
And, overall, after the buy-back, there has been $39 paid on the $100 of company income: that is one layer of tax at Kate's 39% tax rate.
Net tax on 100 income:
Company 30
Kate(39%) 39
Jim (47%) 17
-47
30 + 170 = 200

39
One layer at Kate's tax rate over time
See - it is the same amount of tax that Kate would have paid had she received the $70 of franked dividends herself in the buy-back.
And Jim's tax assessment of the buy-back, summarised as, $100 taxable income offset by $100 capital loss and net $30 tax savings from imputation credits, is independent of his tax rate.
What!! Super funds on 15% will benefit more. And that capital loss is definitely a tax rort. And all shareholders should also get franked dividends. And I question the 30% discount on the buy-back price.
Neat, Claudia!

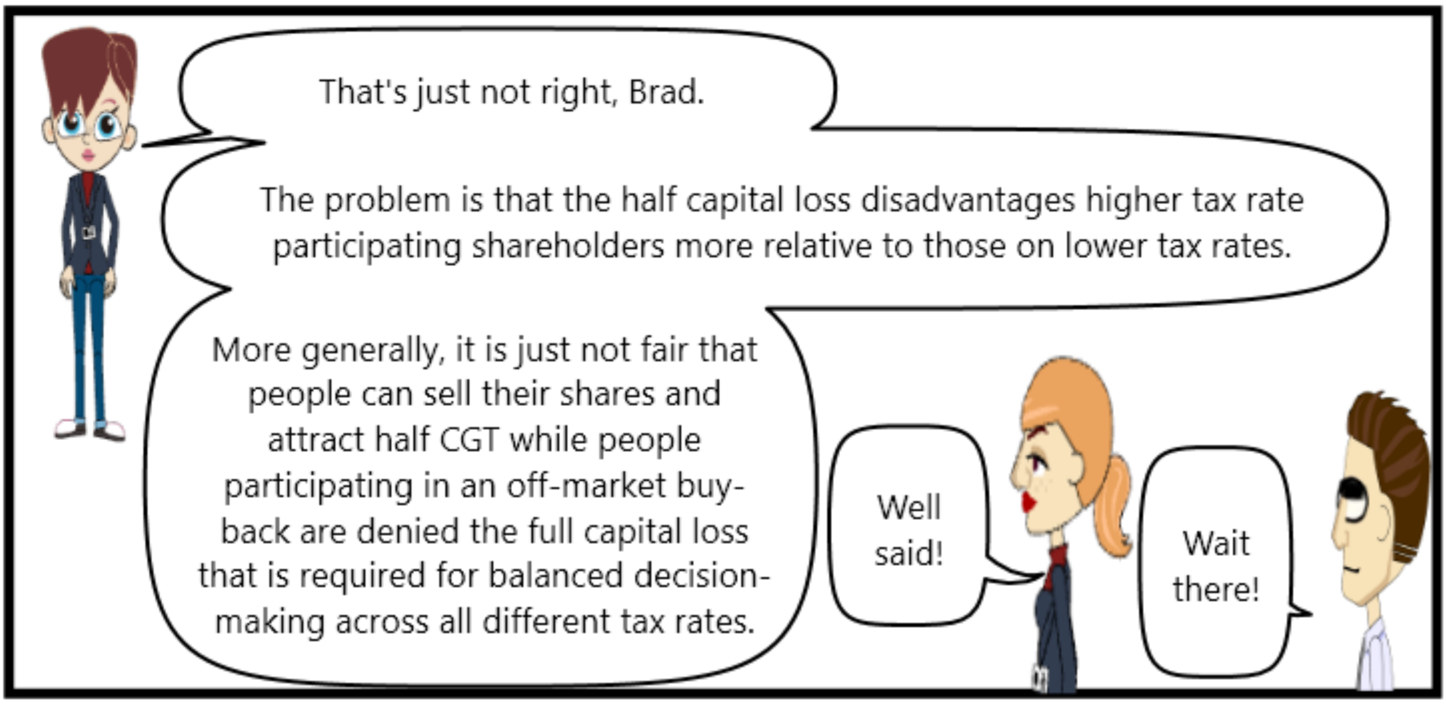

The capital loss just mirrors, in reverse, the capital gain previously realised by Kate when she sold her shares.
CGT applying to share sales is more about maintaining share prices than about raising tax revenue. Imagine the pricing effects if Kate were not subject to CGT at all on her share sales and Jim got no capital loss.
The capital loss looks contrived.
Yes, yes, Sami we will explain to the Committee.
Under integration, Kate would have been taxed on the $100 of retained company income when it was earned and there would be no double tax on her sale to Jim. Share price and buy-back price would be $170.
Under imputation, Brad, Jim would have realised that same $100 capital loss had the company, instead of doing the buy-back, distributed all its retained post-tax income and then Jim sold out for $100.
Or, alternatively, the company sold all its assets and liquidated, distributing all retained income and capital to shareholders.
As discussed, an off-market buy-back, with its cancellation of shares in the bought back slice of the company, can be viewed as a part liquidation.
And, it is important to have consistent tax treatment across these equivalent financial situations that can remove prior double taxation of company profits.
And, Brad, a super fund on a 15% tax rate would get the same net $30 tax savings as Jim.
The fund would get a refund of $15 of the $30 paid by the company plus $15 worth of capital loss.
Remember no CGT discount is assumed.
Oh, yeah, half CGT has to be better.
Well, with half CGT, the buy-back could again offset prior double tax.
But, it suffers from the same fairness and pricing problems as would no CGT.
These two purists again!!

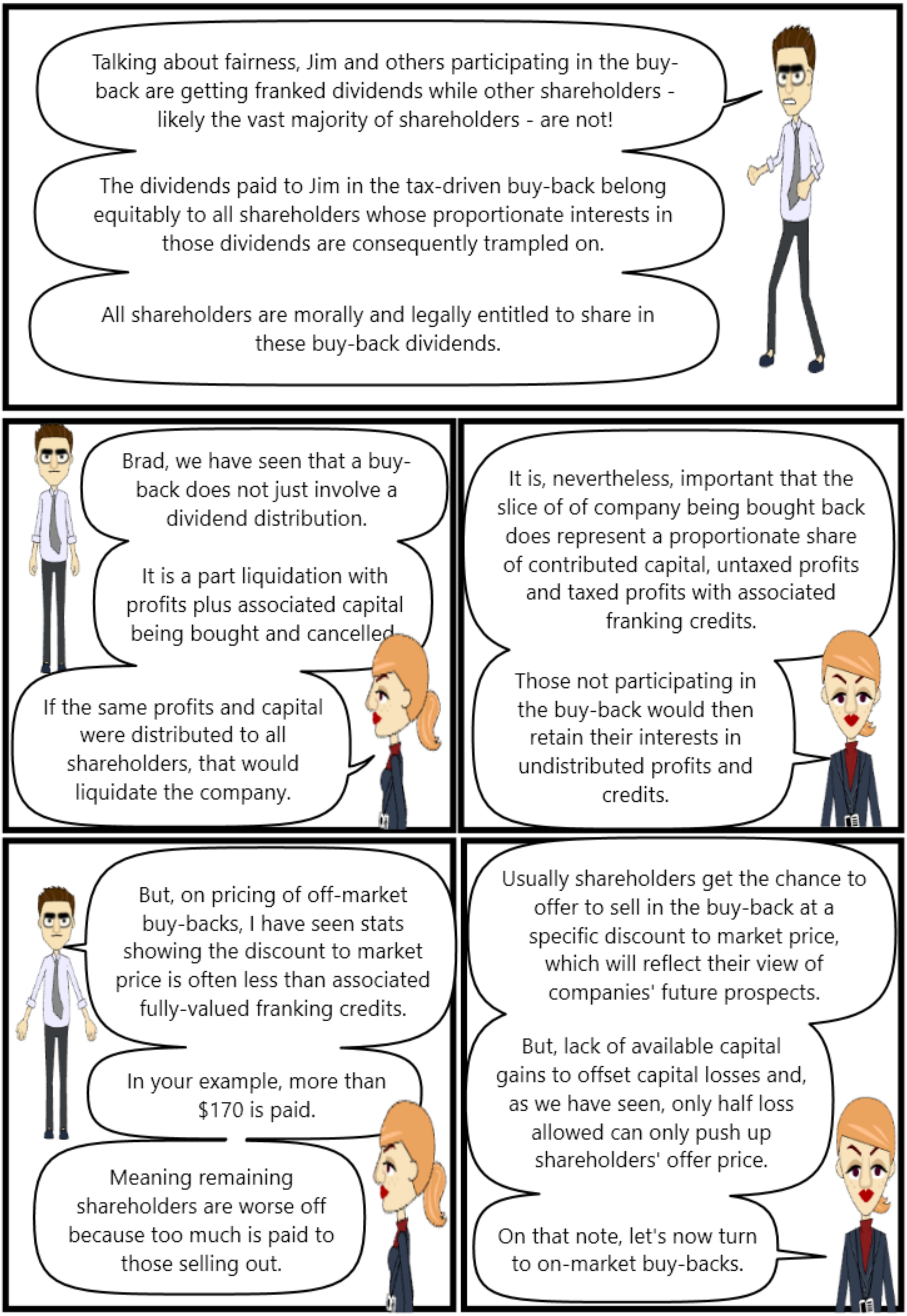

Net tax on 100 income
(50% CGT discount):
Company 30
Kate(39%) 19.5
Jim (47%) 17 -23.5 6.5+170 = 176.5

43
More than one layer at Kate's tax rate over time
Look. I have just done some numbers on the impact of half CGT.
With half CGT applying, let's first keep Jim on a 47% tax rate.
Then, while Kate benefits from half CGT, the value to Jim of his $100 capital loss is only $23.5 instead of $47.
More than than one layer of tax at Kate's tax rate is paid overall because Jim only nets $176.5 from the buy-back instead of $200.
Nice, Sami. Lots of share price effects, too.

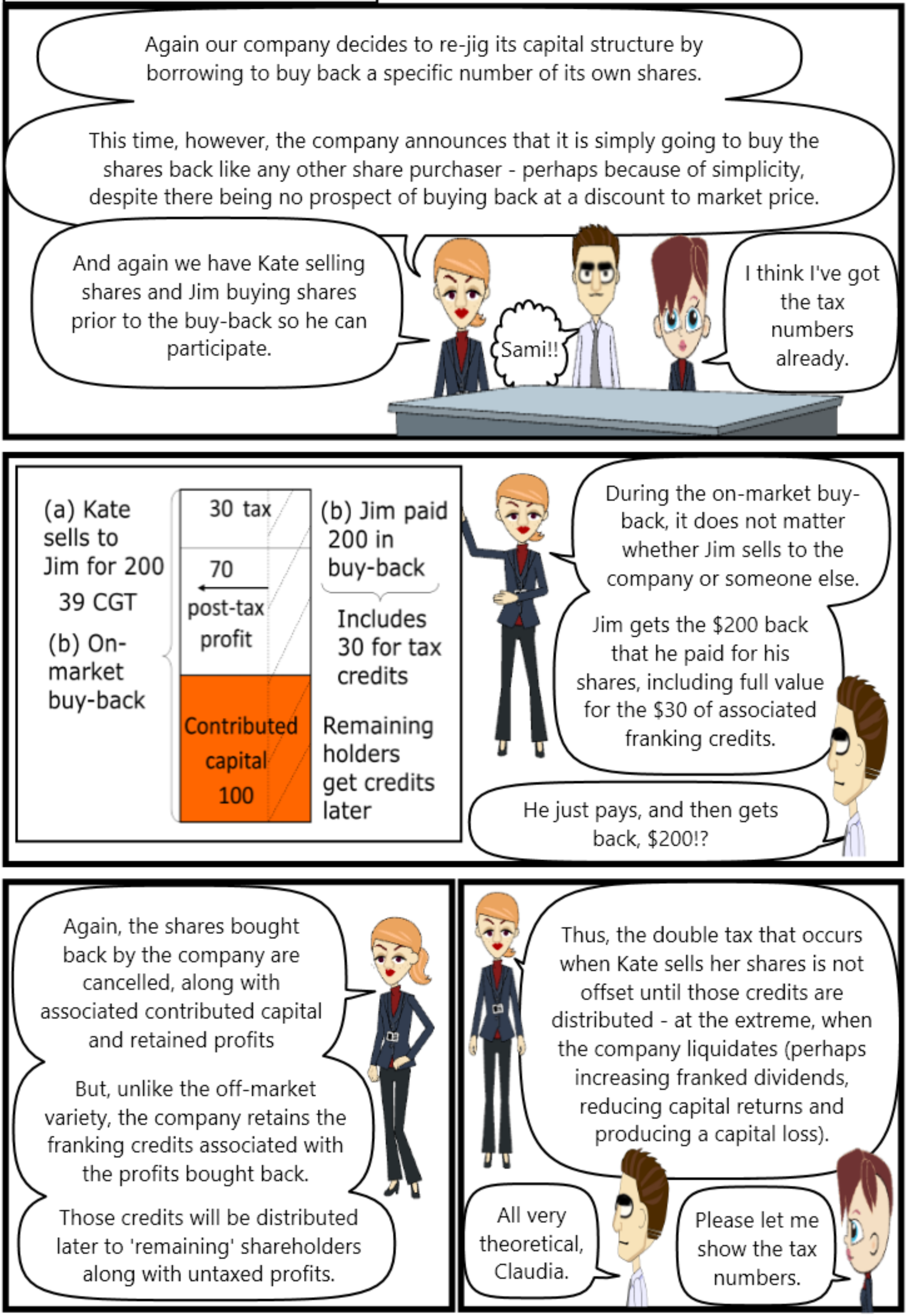

Net tax on 100 income
(50% CGT discount):
Company 30
Kate(39%) 19.5
Jim (15%) -15 -7.5 22.5+170 = 192.5

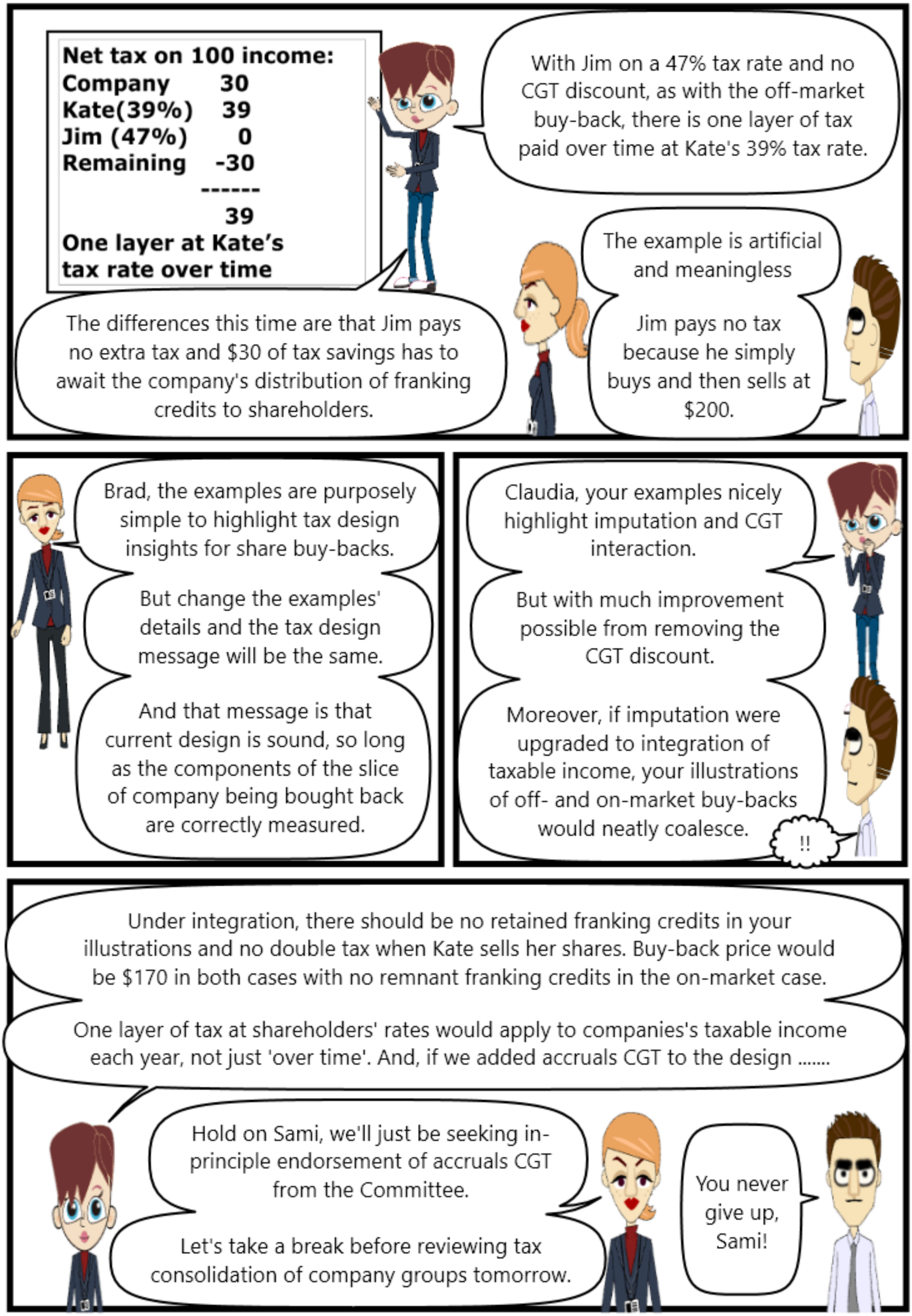
27
Less than one layer at Kate's tax rate over time
And, see what happens if Jim is on a 15% tax rate.
Kate still benefits from half CGT.
But, Jim nets $192.5, much closer to the $200 cost of his shares than when he is on a 47% tax rate
On a 0% tax rate, say in super pension mode, Jim would net the full $200 from $30 of credits.
Nice one, Sami.
So? We all know franking credits are better for those on lower tax rates.


That's just not right, Brad.
The problem is that the half capital loss disadvantages higher tax rate participating shareholders more relative to those on lower tax rates.
More generally, it is just not fair that people can sell their shares and attract half CGT while people participating in an off-market buy-back are denied the full capital loss that is required for balanced decision-making across all different tax rates.
Well said!
Wait there!


Talking about fairness, Jim and others participating in the buy-back are getting franked dividends while other shareholders - likely the vast majority of shareholders - are not!
The dividends paid to Jim in the tax-driven buy-back belong equitably to all shareholders whose proportionate interests in those dividends are consequently trampled on.
All shareholders are morally and legally entitled to share in these buy-back dividends.
Brad, we have seen that a buy-back does not just involve a dividend distribution.
It is a part liquidation with profits plus associated capital being bought and cancelled.
If the same profits and capital were distributed to all shareholders, that would liquidate the company.
It is, nevertheless, important that the slice of of company being bought back does represent a proportionate share of contributed capital, untaxed profits and taxed profits with associated franking credits.
Those not participating in the buy-back would then retain their interests in undistributed profits and credits.
But, on pricing of off-market buy-backs, I have seen stats showing the discount to market price is often less than associated fully-valued franking credits.
In your example, more than $170 is paid.
Meaning remaining shareholders are worse off because too much is paid to those selling out.
Usually shareholders get the chance to offer to sell in the buy-back at a specific discount to market price, which will reflect their view of companies' future prospects.
But, lack of available capital gains to offset capital losses and, as we have seen, only half loss allowed can only push up shareholders' offer price.
On that note, let's now turn to on-market buy-backs.

On-market share buy-back





Net tax on 100 income:
Company 30
Kate(39%) 39
Jim (47%) 0
Remaining -30

39
One layer at Kate's tax rate over time
With Jim on a 47% tax rate and no CGT discount, as with the off-market buy-back, there is one layer of tax paid over time at Kate's 39% tax rate.
The differences this time are that Jim pays no extra tax and $30 of tax savings has to await the company's distribution of franking credits to shareholders.
The example is artificial and meaningless
Jim pays no tax because he simply buys and then sells at $200.
Brad, the examples are purposely simple to highlight tax design insights for share buy-backs.
But change the examples' details and the tax design message will be the same.
And that message is that current design is sound, so long as the components of the slice of company being bought back are correctly measured.
Claudia, your examples nicely highlight imputation and CGT interaction.
But with much improvement possible from removing the CGT discount.
Moreover, if imputation were upgraded to integration of taxable income, your illustrations of off- and on-market buy-backs would neatly coalesce.
!!
Under integration, there should be no retained franking credits in your illustrations and no double tax when Kate sells her shares. Buy-back price would be $170 in both cases with no remnant franking credits in the on-market case.
One layer of tax at shareholders' rates would apply to companies's taxable income each year, not just 'over time'. And, if we added accruals CGT to the design ....
Hold on Sami, we'll just be seeking in-principle endorsement of accruals CGT from the Committee.
Let's take a break before reviewing tax consolidation of company groups tomorrow.
You never give up, Sami!