Submission on Improving the integrity of off-market share buy-backs

From Lorraine Graham

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Thank you for the opportunity to contribute to the discussion on this topic. I am a self-funded retiree with an SMSF and I have been an active share market investor for almost thirty years.

While I agree in principle with the proposed changes to the tax treatment of off-market buybacks, I would like to make some comments on the proposed cancellation of franking credits by debiting them from the company's franking account when shares are bought back by a company.

1. Benefit of the franking system as it now stands

The franking system was introduced to prevent the double taxation of dividends and has worked well since its first introduction and later modification to make the excess franking credit refundable to low-tax-rate investors.

It encourages companies to raise share capital rather than funding their operations through debt, which in turn allows and encourages Australian retail shareholders to benefit from the prosperity and enterprise of our economy.

This has helped us all, companies and shareholders alike, through the global financial crisis and the Covid crisis, particularly self-funded retirees who have benefited from dividends paid at times when bank interest was so low that retirees without access to the age pension would have been without even a subsistence income from term deposits.

In its simplest form, the franking system is fair to all stakeholders. Tax paid on behalf of the shareholders of the company is either passed on with the franked dividends or retained in the franking account to pass on, with the retained earnings, at a later date.

Dismantling this system in any way would be a backwards step for us as a nation. Although there are arguments that the franking system is costing the government billions of dollars in the pre-paid tax they are returning, in truth it is no different from the ATO returning pay-as-you-earn tax that has been taken from salary and wages in excess of the amount owed. There would be an uproar if excess pay-as-you-earn tax was not refundable.

If the government is concerned over the amount that is being refunded, then they should address the real problem with the system, which is the rise and rise of the number of low-rate and zero-rate taxpayers, principally pension mode super funds. We have already reduced this problem by capping pension mode super and could reduce it further with caps on total super.

2. Off-Market buybacks are artificial and unnecessary

Over the past few years, some companies have set up complex and rather artificial share buy-backs using excess funds. The company can buy back their shares at below the market price because part of the consideration given is franking credit that the company would otherwise be unlikely to return to their shareholders. The zero-tax-rate shareholders who accept these offers can claim back the franking credit and thereby receive more overall for their shares than selling them on market.

This process is always complex, oversubscribed, and of minimal and dubious benefit to shareholders, as the buy-backs are always highly discounted and scaled back. Companies do gain from funding the buyback in part from tax paid in the past, but overall they are contrived arrangements.

If the company has excess funds, it would be fairer to pay all shareholders a special franked dividend, or a return of capital. Zero-tax-rate shareholders would still receive their refunded franking credit, while top-tax-rate shareholders would pay some additional tax. This keeps the system simple and more in line with its intended purpose.

3. Debiting franking account balances is unfair

While I agree with the decision to disallow off-market share buybacks structured in this way, I do object to the franking account being debited for the amount of tax proportional to the number of shares bought back and the component of the price that is not funded from share capital.

To me this is analogous to, and just as bizarre as, reducing the tax a company owes on its current year profit just because it bought back some of its shares.

Regardless of the number of shares a company has, the franking balance is all tax that the company has paid on profits in the past, and the remaining shareholders have the right to retain all of it.

From what I have managed to ascertain from reading the explanatory memorandum and the tax legislation in ITAA Section 205.30.9, this reduction of the franking account has been the case for on-market buybacks of shares for some time, and off-market buybacks are being aligned to this.

I feel that this is, and always has been, unfair, as the tax has been paid in the past and should not simply disappear when its corresponding profit has been used in a buyback.

I realise that there is a problem here as dividends paid out can only be franked to the extent of the profit, current and retained, being paid out, some of which would have gone to pay for the buyback. The purpose of Section 205.30 is to keep the balance of the franking account in line with the value of the retained profit as well as adjusting the franking balance to reflect tax paid by and refunded to the company.

But perhaps the answer is for companies to only fund buybacks from the capital account and return excess funds to all shareholders from the retained profits as a franked dividend. In any case companies will choose to do this if they are acting in the best interests of their shareholders. If companies are really keen to reduce the number of shares on issue, they are able to do this with a share consolidation. As far as I can ascertain, this would have no effect on the franking account balance.

4. Likely consequences of this proposed legislation

If this legislation is passed in its current form, then off-market buybacks will cease to be viable in normal circumstances.

If the buyback price is above the current market price, then the company will be better off buying the shares with an on-market buyback.

If the buy-back price offered is the same as the current market price, then the shareholders will gain nothing beyond saving the cost of brokerage, although this may be of benefit to shareholders with very small parcels of shares.

If the buy-back price is less than the current market price, then only the silliest of shareholders would take up the offer.

On-market buybacks would continue as now with their rules unchanged.

For companies with excess funds that they wish to return to shareholders, a better and more fair option would be to pay a capital return to all shareholders if the excess is held as capital, or a franked dividend if the excess is paid from retained earnings. This treats all shareholders equally and distributes franking credits fairly.