Share and share alike: share buybacks after TD2004/D1

KIM WYATT and **JARROD MCDONALD** look at some of the tax implications of share buybacks.

Over the last decade share buybacks have become an increasingly popular option for companies due to the relaxing of Australia's buyback legislation in 1995 (a share buyback is when a company buys back its own shares from its shareholders. These shares are then cancelled, reducing the overall number of shares on issue).

Buybacks enable companies to more efficiently manage their capital while returning surplus funds and distributing excess franking credits to shareholders. The benefit to companies is better utilisation of excess cash, and a buyback signals to the market that their shares are presently undervalued.

Off-market share buybacks are also advantageous to shareholders, in that no transaction costs are incurred, unlike selling on the market. The buybacks are therefore considered a cost-effective way for smaller shareholders to dispose of their holdings.

Warren Buffett, Chairman of Berkshire Hathaway and well known for his investment strategies, believes that a combination of factors needs to be present for a company to undertake a share buyback:

1. The company must have surplus funds above and beyond its requirements to maintain market share and business growth;
2. The stock is selling on the market below its intrinsic value, and shareholders must be supplied with information to estimate the intrinsic value (Berkshire Hathaway 1999 Annual Report).

Since the buyback-related amendment to the Corporations Law in 1995, over 35 off-market buybacks have taken place. Companies, such as Telstra, Foster's and Woolworths have participated in off-market buybacks.

These companies have sought a taxation ruling which until this year (Pre TD 2004/D1) allowed them to split the buyback price between a capital amount and an amount deemed to be a fully franked dividend. This resulted in tax advantages for some investors, although the pattern that has emerged from previous analysis of these buybacks has revealed that the structure of the buybacks has only been advantageous for super funds and individuals on low marginal tax rates (MTRs).

In contrast, shareholders on higher MTRs of 43.5% or 48.5% were better-off selling on the market at the close of the tender period.

Draft determination TD 2004/D1

This year on 14 January, the Australian Taxation Office (ATO) issued Draft Taxation Determination TD 2004/D1, which proposes to reduce the tax benefits that have been associated with off-market buybacks of shares in listed companies.

TD 2004/D1 is contrary to previous ATO rulings in that it now applies a special rule in the tax law designed to stop the artificial inflation of capital losses. This determination will now allow the ATO to decide the market value of the shares at the time of the buyback.

The difference between the market value and the final tender price will now be added to the capital proceeds of the buyback when calculating the shareholder's capital gain/loss, thus reducing the tax benefit to the shareholder. Previously, the capital component of the buyback was not adjusted in determining the shareholder's capital gain/loss.

The market value at the time of the buyback will now be determined as a volume weighted average closing price (VWACP) of the company's shares on the Australian Stock Exchange (ASX), calculated from prices over the five

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TABLE 1 CBA NEW RULES
TAX IMPLICATIONS OF PARTICIPATING IN THE CBA'S BUYBACK FOR RESIDENT SHAREHOLDER ON VARIOUS MARGINAL TAX RATES COMPARED WITH SELLING ON MARKET ON DAY TENDER CLOSES (INCORPORATING TD 2004/D1)

							Super Fund
Variables							
CBA Buyback Price	$27.50	$27.50	$27.50	$27.50	$27.50		$27.50
Tax Value	$30.42	$30.42	$30.42	$30.42	$30.42		$30.42
MTR	0.0%	18.5%	31.5%	43.5%	48.5%		15.0%
Market Price	$33.22	$33.22	$33.22	$33.22	$33.22		$33.22
1% Brokerage	$0.33	$0.33	$0.33	$0.33	$0.33		$0.33
Market Price Less Brokerage	$32.89	$32.89	$32.89	$32.89	$32.89		$32.89
Assumed Cost Base	$20.00	$20.00	$20.00	$20.00	$20.00		$20.00
Capital Component of Buyback	$11.00	$11.00	$11.00	$11.00	$11.00		$11.00
Take CBA offer Dividend Consequences							
Fully Franked Dividend	$16.50	$16.50	$16.50	$16.50	$16.50		$16.50
Franking Credit	$7.07	$7.07	$7.07	$7.07	$7.07		$7.07
Assessable Income	$23.57	$23.57	$23.57	$23.57	$23.57		$23.57
Tax on that assessable Income	$–	$4.36	$7.43	$10.25	$11.43		$3.54
After tax Proceeds	$23.57	$19.21	$16.15	$13.32	$12.14		$20.04
Capital gains Consequences							
Capital Component of Buyback	$11.00	$11.0 0	$11.00	$11.00	$11.00		$11.00
Adjust for excess tax value	$2.92	$2.92	$2.92	$2.92	$2.92		$2.92
Assumed Cost Base	$20.00	$20.00	$20.00	$20.00	$20.00		$20.00
Nominal Capital/gain/loss	–$6.08	–$6.08	–$6.08	–$6.08	–$6.08		–$6.08
Discounted Capital Gain/Loss	–$3.04	–$3.04	–$3.04	–$3.04	–$3.04		–$4.05
Tax impact of gain/loss	$–	–$0.56	–$0.96	–$1.32	–$1.47		–$0.61
After tax proceeds	$11.00	$11.56	$11.96	$12.32	$12.47		$11.61
Total After Tax Proceeds	$34.57	$30.77	$28.10	$25.64	$24.61		$31.64
Sell on Market							
Mkt Price less Brokerage	$32.89	$32.89	$32.89	$32.89	$32.89		$32.89
Nominal Capital/gain/loss	$12.89	$12.89	$12.89	$12.89	$12.89		$12.89
Discounted Capital Gain/Loss	$6.44	$6.44	$6.44	$6.44	$6.44		$8.59
Tax impact of gain/loss	$–	$1.19	$2.03	$2.80	$3.13		$1.29
Total After Tax Proceeds	$32.89	$31.70	$30.86	$30.08	$29.76		$31.60
Gain/Loss per share if accept buyback	$1.684	–$0.923	–$2.754	–$4.444	–$5.149		$0.045
Gain/Loss for 5000 shares if accept buyback	$8,418	–$4,613	–$13,770	–$22,222	–$25,744		$223
Gain/Loss per share if accept buyback pre TD2004/D1	$1.684	–$0.652	–$2.294	–$3.809	–$4.441		$0.337
Cost per share due to TD2004/D1	$–	$0.270	$0.460	$0.635	$0.708		$0.292

trading days prior to the announcement of the buyback.

This price is then adjusted for the percentage change in the S&P/ASX 200 Index from the commencement of trading on the announcement date (the opening S&P/ASX 200 Index) to the close of trading on the day the buyback closes (the closing S&P/ASX 200 Index). That is:

$$\text{VWACP over last 5 trading days} \times \frac{\text{Closing S\&P/ASX 200 Index}}{\text{Opening S\&P/ASX 200 Index}}$$

TD 2004/D1 has been applied this year to the Commonwealth Bank (CBA), Insurance Australia Group (IAG) and Westpac Banking Corporation (Westpac). A spreadsheet model has been developed that analyses the effectiveness of these companies' buybacks for individual shareholders at varying MTRs, and for super funds which are taxed at 15%.

The model compares the buyback price, comprising the capital and dividend component, with the price that would be obtained by selling the shares directly on the market. These differences remain the same even with varying cost bases. (See Appendix 1 for an illustration of this concept). A comparison has also been undertaken to assess the financial effect of TD 2004/D1 on shareholders. This will demonstrate how the ATO's changes have affected the comparative gains of opting to participate in a buyback or selling the shares on the open market.

The analysis has the following assumptions:

1. The MTRs include a Medicare Levy of 1.5%;
2. Individual and super funds are fully entitled to the franking credits;
3. Capital losses incurred can be fully offset against capital gains;
4. The discount capital gain method applies;
5. The market price for each company is at close of trading on the last day of the buyback offer. Brokerage of 1% has been allowed for the alternative of selling on the open market;
6. Amounts have been rounded to the nearest cent.

CBA's buyback tender opened on 8 March and closed on 26 March, 2004. On the date of the buyback announcement, CBA's VWACP over the last 5 days was $29.16. The S&P/ASX 200 Index increased over the tender period, resulting in an ATO-determined market value of $30.42 at close of tender.

On 29 March, CBA announced the completion of its off-market share buyback. A total of 19,360,759 shares were bought back at $27.50 per share at a total cost of $532.4 million. The final trading price of CBA shares on Friday, 26 March was $33.22. The buyback price of $27.50 included a fully franked dividend of $16.50 per share and $11.00 of capital proceeds.

For capital gains tax purposes, an Australian resident individual or complying superannuation entity shareholder participating in the buyback will now be deemed to have disposed of each of their CBA shares for $13.92; this amount being the deemed capital proceeds of $11.00 ($27.50 - $16.50) plus $2.92, which is the amount by which the ATO-determined market value ($30.42) exceeds the buyback price ($27.50).

This additional $2.92 will reduce the tax benefit for individuals by [(1/2 x $2.92) x MTR] per share. Performing the calculations for each MTR reveals that the higher the MTRs, the greater the reductions in tax benefits. That is, a shareholder's benefit in taking the buyback offer will now be reduced by 27c, 46c, 64c or 71c for MTRs of 18.5%, 31.5%, 43.5% or 48.5% respectively, due to the introduction of TD 2004/D1. The reduced benefit for super funds is [(2/3 x $2.92) x 15%]; being 29c per share or $1,460 for a holding of 5,000 shares.

Table 1 details the analysis of opting to participate in the CBA buyback versus selling on the open market, after applying the ATO's new approach to determining the market value of the shares bought back. The analysis revealed that all resident individual shareholders with a MTR of 18.5% or more would have been better off selling their shares on the open market on Friday, 26 March at the closing price of $33.22.

An individual shareholder with an MTR of 48.5% who opted to accept the CBA buyback offer instead of selling on the open market would have been worse off by the material amount of $5.15 per share ($25,744 for 5,000 shares), entailing a loss of 15.5% on each share held, compared to the closing market price.

Pre TD 2004/D1 would have resulted in this shareholder being worse off by the smaller amount of $4.44 per share. Super funds still benefited from participating in the buyback, though only marginally (by 4.5c per share or $223 for 5,000 shares). In contrast, pre-TD 2004/D1 would have resulted in super funds being better-off by 33.7c per share ($1,683 for 5,000 shares).

Therefore the winners in this buyback offer would appear to be the CBA and its remaining shareholders. As stated by the Bank's Chief Executive Officer, Mr. Murray, in their media release on Monday 29th March: "For shareholders who retain their shares, the buyback price represents a very efficient price for the bank to repurchase its shares and thereby enhances earnings per-share and long-term shareholder value."

Indeed, the buyback price of $27.50 was a very efficient price for the bank, but not for most of those shareholders who took up the offer. Less than two months later on 19 May, the CBA invited shareholders to participate in a $250 million share purchase plan at an issue price of $31.36. This represents a gain to the CBA of $3.86 per share on the 8 million shares it sold back to its shareholders. It leaves open to question why on the one hand the CBA would buy back $532 million of shares only to then invite shareholders to participate in a $250 million share purchase plan two months later.

Westpac also announced on 21 June, 2004 the successful completion of its structured off-market share buyback. The buyback tender period closed on Friday 18 June and the buyback price was set at $14.50 per share.

The final trading price of Westpac shares on Friday, 26 March was $17.28. The buy back price is treated as a fully franked dividend of $10.50 per share and a capital component of $4 per share.

In accordance with TD 2004/D1, the deemed disposal price for capital gains tax purposes for shares sold under the buy back is $17.71 which exceeds the buyback price by $3.21. For capital gains tax purposes, an Australian resident individual or complying superannuation entity shareholder whose shares are bought back will be deemed to have disposed of each share for capital proceeds of $7.21.

As was the case with CBA, this additional $3.21 will reduce the tax benefit for individuals taking up the buyback by [(1/2 x $3.21) x MTR] per share. That is, a shareholder's benefit in taking the buyback offer will now be reduced by 30c, 51c, 70c or 78c for MTRs of 18.5%, 31.5%, 43.5% or 48.5% respectively, due to the introduction of TD 2004/D1. The reduced benefit for super funds is [(2/3 x $3.21) x 15%]; being 32c per share or $1,605 for a holding of 5000 shares.

Table 2 summarises the analysis of opting to participate in the Westpac buyback versus selling on the open market. Shareholders with an MTR of 18.5% or less should have participated in the buyback rather than selling on the market.

Conversely, shareholders on a higher MTR who wanted to liquidate their shares would have been better off selling on the market at the close of the tender period. Again, the analysis indicates that buybacks are beneficial for super funds, as a fund would gain 63 cents per share ($3,163 for 5000 shares) by participating in the buyback, even though the market price of the share was $2.78 above the buyback price. Had the buyback been undertaken pre-TD 2004/D1, then super funds would have benefited by 95 cents per share.

Chief Financial Officer, Philip Chronican said the successful completion of the buyback would benefit all Westpac shareholders. "Shareholders who sold shares into the buyback may receive certain tax benefits, depending on their individual circumstances. For shareholders who retained their shares, the buyback enhances future earnings per share while creating a more efficient capital structure."

Again, it would appear that existing shareholders may well be the winners along with super funds and shareholders on low MTRs who participated in the buyback.

IAG announced on 21 June that it had successfully completed its off-market share buyback of 94.1 million shares at $4.40 per share for a total of $414 million representing around 5.6% of IAG's ordinary shares on issue.

Shares in IAG closed at $5.01 on Friday 18th June being the last day of the tender. The buyback price of $4.40 is comprised of a capital component of $1.78 and a $2.62 fully franked dividend. In accordance with TD2004/D1, the market value of the shares bought back for tax purposes is $4.78 per share, which exceeds the buyback price by $0.38.

For capital gains tax purposes, an Australian resident individual or complying superannuation entity shareholder whose IAG shares are bought back will be deemed to have disposed of each share for capital

TABLE 2 **WESTPAC NEW RULES**
TAX IMPLICATIONS OF PARTICIPATING IN THE WESTPAC'S BUYBACK FOR RESIDENT SHAREHOLDER ON VARIOUS MARGINAL TAX RATES COMPARED WITH SELLING ON MARKET ON DAY TENDER CLOSES (INCORPORATING TD 2004/D1)

							Super Fund
MTR	0.0%	18.5%	31.5%	43.5%	48.5%		15.0%
Gain/Loss per share if accept Buyback	$1.893	$0.033	–$1.273	–$2.480	–$2.982		$0.633
Gain/Loss for 5000 shares if accept buyback	$9,464	$166	–$6,367	–$12,398	–$14,911		$3,163
Gain/Loss per share if accept buyback pre TD2004/D1	$1.893	$0.330	–$0.768	–$1.781	–$2.204		$0.954
Cost per share due to TD2004/D1	$–	$0.297	$0.506	$0.698	$0.778		$0.321

TABLE 3 **IAG NEW RULES**
TAX IMPLICATIONS OF PARTICIPATING IN THE IAG'S BUYBACK FOR RESIDENT SHAREHOLDER ON VARIOUS MARGINAL TAX RATES COMPARED WITH SELLING ON MARKET ON DAY TENDER CLOSES (INCORPORATING TD 2004/D1)

							Super Fund
MTR	0.0%	18.5%	31.5%	43.5%	48.5%		15.0%
Gain/Loss per share if accept buyback	$0.563	$0.130	–$0.175	–$0.456	–$0.573		$0.282
Gain/Loss for 5000 shares if accept buyback	$2,815	$648	–$875	–$2,281	–$2,867		$1,408
Gain/Loss per share if accept buyback pre TD2004/D1	$0.563	$0.165	–$0.115	–$0.374	–$0.481		$0.320
Cost per share due to TD2004/D1	$–	$0.035	$0.060	$0.083	$0.092		$0.038

proceeds of $2.16. This additional $0.38 will reduce the tax benefit for individuals taking up the buyback by [(1/2 x $0.38) x MTR] per share. That is, a shareholder's benefit in taking the buyback offer will now be reduced by 3.5c or 9.2c for MTRs of 18.5% or 48.5% respectively, due to the introduction of TD 2004/D1.

The reduced benefit for super funds is [(2/3 x $0.38) x 15%]; being 3.8c per share or $190 for a holding of 5,000 shares. The differential in regard to IAG is less compared to CBA and Westpac as the disparity between the buyback price and the deemed ATO market value is less.

Table 3 summarises the analysis of opting to participate in the IAG buyback versus selling on the open market. Shareholders with an MTR of 18.5% or less should have participated in the buyback rather than selling on the market.

Conversely, shareholders on a higher MTR who wanted to liquidate their shares would have been better off selling on the market at the close of the tender period. Again, the analysis indicates that buybacks are beneficial for super funds, as a fund would gain 28 cents per share ($1,408 for 5,000 shares) by participating in the buyback, even though the market price of the share was 61 cents above the buyback price.

IAG's Chief Financial Officer Mr George Venardos said, "For shareholders who retained their shares, the final buyback price represents a very efficient price for the Group to purchase its shares. The final buyback price represents a 12% discount to the closing price of IAG shares on Friday, 18 June 2004."

Conclusion

The fact that companies are able to set a buyback price well below the market rate suggests that shareholders are not doing their homework. The impact of recent buybacks, together with the new tax determination, has shown that careful analysis is needed before shareholders elect to be part of a company's buyback schemes.

TD2004/D1 has further reduced the benefits to shareholders participating in a share buyback. The greater the differential between the determined buyback price and the ATO-determined market value, then the greater the loss in tax benefits to the shareholder participating in the buyback.

Prudent investors should conduct their analysis closer to the last day of the tender period before putting in a tender price for their shares. Further it would appear that for shareholders on high MTRs, participation in a share buyback should not be considered.

However, super funds even with the reduced tax benefits of TD2004/D1 are still the big winners from off-market share buybacks.

Perhaps when companies are cashed up and wish to consider returning cash to their shareholders (as announced by Telstra on 21 June), they might consider a special dividend to all shareholders which distributes the tax advantages evenly to all shareholders rather than executing a buyback that will only benefit a few.

It may be that as shareholders come to grips with understanding the potential gains or losses of participating in a buyback, and understanding the effect this new tax determination can have on their decision making, then the cost to a company undertaking a share buyback may increase. Shareholders would be more likely to demand a higher buyback price to compensate for the reduced tax benefit.

Appendix 1

Proof that varying cost base of CBA Shares will not affect the difference between the after tax proceeds of selling on the market and the after tax proceeds of accepting the Bank's buyback offer.

Let: c = Cost Base of Shares
m = Marginal Tax Rate

<u>Accept CBA Buy Back</u>

The fully franked dividend of $16.50 will raise an imputation credit of $7.07 resulting in an assessable income of $23.57 per share. This will be taxed at the MTR. The after tax proceeds will be

$23.57 (1 – m) = $23.57 - $23.57m
The capital component is $11.00.

Applying the discount capital gains method and the deemed disposal price of $13.92, then the after tax proceeds will be:

$11.00 – [0.5($13.92 – c)] m = $11.00 - $6.96m + 0.5cm

Therefore the total after tax proceeds of the deemed dividend of $16.50 and the capital component of $11.00 is:

$34.57 - $30.53m + 0.5cm

<u>Sell Shares on Market at $33.22 per share</u>

Here the disposal price is $32.89 after brokerage. The after tax proceeds will be:

$32.89 – [0.5($32.89 – c)] m = $32.89 - $16.445m + 0.5cm

<u>Difference between accepting CBA buyback offer and selling on the market is:</u>

$34.57 - $30.53m + 0.5cm – ($32.89 - $16.445m + 0.5cm)
= $34.57 - $30.53m + 0.5cm - $32.89 + $16.445m - 0.5cm
= $1.68 - $14.085m

Therefore in calculating the difference, the original cost base of the shares is not in the formula.

Proof: Let m = MTRs of 18.5%, 31.5%, 43.5% and 48.5%

At 18.5%, difference = $1.68 - ($14.085 x 18.5%) = -$0.92
At 31.5%, difference = $1.68 - ($14.085 x 31.5%) = -$2.75
At 43.5%, difference = $1.68 - ($14.085 x 43.5%) = -$4.44
At 48.5%, difference = $1.68 - ($14.085 x 48.5%) = -$5.15

These figures agree with Table 1. It also highlights that in regard to any company share buyback, the original cost base of the shares doesn't come into calculation when comparing the difference between selling on the market or accepting the company's buyback offer. J