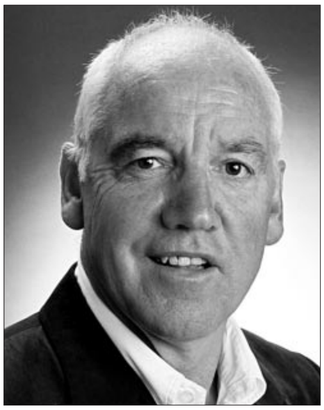
Off-market tender buybacks not driven by tax benefits

While shareholders may gain some tax benefits from participating in share market buybacks, our research shows that prices offered by shareholders in off-market tender buybacks in Australia are not driven by tax consequences alone.



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SHARE MARKET BUYBACKS in Australia are a relatively recent phenomenon. Prior to amendments to the former Companies Code in 1989, onerous legal and administrative requirements made buybacks unattractive.[1] Until further changes were made in 1995, legal complexity and compliance costs, directors' personal liability and accounting complexity[2] were identified as key reasons why buybacks remained unpopular with Australian companies. However, liberalisation of the legislation in 1995 led to a significant increase in the number of share buybacks undertaken by Australian companies.[3]

Studies have indicated numerous reasons for buyback activity such as a return of excess cash and a method of increasing the share price. In addition to these factors, taxation has been found to be a significant determinant of buyback activity in the United Kingdom[4] and the United States.[5] In particular, Anderson and Dyl stated that in the United States, 'Many self-tender offers may essentially be tax advantaged cash dividend payments in disguise'.[6]

The self-tender offers that Anderson and Dyl refer to are a recent development in the structure of buybacks in Australia. Originally, companies offered a fixed price tender where shares were repurchased at a single price point determined by the company. Self-tender buybacks involve the company setting a number of price points at which shareholders may tender some or all of their shares. The company, which has set the parameters of the buyback, particularly the number of shares to be repurchased, will then accept the tenders stipulating the lowest price points until the predetermined number of shares has been bought back. Such buybacks have become increasingly popular in Australia over the past five years, with at least some commentators suggesting that this is driven by tax considerations.[7] These tax considerations have become so significant that the Board of Taxation has conducted an inquiry into the appropriate tax treatment of self-tender off-market buybacks.[8]

Division 16K of the *Income Tax Assessment Act 1936*[9] distinguishes between on and off-market buybacks. On-market buybacks are those that occur in the ordinary course of trading on an official stock exchange and essentially require that the entire repurchase price is capital in the hands of the shareholder, with the resultant capital gains tax consequences.

Off-market buybacks are dealt with under Subdivision C of Division 16K which allows the company to split the repurchase price between a frankable dividend and a capital component. The mechanism by which this is achieved is somewhat complex and a detailed account of the taxation treatment of buybacks is beyond the scope of this paper.

The tax benefit for shareholders is therefore the opportunity to realise a capital loss and attract franking credits while receiving market value for their shares.

Tax benefits

The ability to split the repurchase price into dividend and capital components in the hands of the shareholders makes off-market buybacks an attractive proposition for many shareholders. For example, a listed company could repurchase its shares that are currently trading for $10 per share (that is, market value). Under normal circumstances, this would generate a capital gain or loss for the shareholder equal to the difference between $10 and their cost base. Assuming the shareholder initially acquired the share for $6 and never incurred any other costs that would add to the share's cost base, the capital gain would be $10 – $6= $4.

Assume further that the company has large cash reserves generated from past profits, and decides to return excess cash to shareholders by repurchasing its shares for $10. The company then debits, say, $3 against its share capital account.[10] The difference of $7 between the repurchase price ($10) and the debit to share capital ($3) is deemed to be a dividend under s. 159GZZZP(1). Further, due to ss. 159GZZZQ(3) and (4), the capital proceeds of the buyback for the shareholder are deemed to be $3, resulting in a capital loss of $3 ($6 cost base less $3 deemed capital proceeds). This $3 capital loss may be used to offset the shareholder's other capital gains either in that tax year or a future tax year.[11]

While the shareholder has to include the $7 dividend in their assessable income under s. 44(1), this $7 is fully frankable (since the repurchase price did not exceed market value at the time of the buyback). Assuming that the company has satisfied all relevant requirements, including having sufficient credits in its franking account, the shareholder receives a tax offset (credit) of $3. Depending on the shareholder's marginal tax rate and other tax liabilities, this $3 may, in whole or in part, be offset against other tax liabilities (for example, tax payable on salary and wages) or refunded if in excess of these other tax liabilities.[12]

The tax benefit for shareholders is therefore the opportunity to realise a capital loss and attract franking credits while receiving market value for their shares.

In cases where the repurchase price is less than the market value of the share at the time of the buyback, s. 159GZZZQ(2) operates to increase the repurchase price. Under these circumstances, the repurchase price is deemed to be the market value just referred to. While the capital proceeds for capital gains tax purposes is still reduced under ss. 159GZZZQ(3) and (4) in the fashion described above (if part of the repurchase price constitutes a dividend), the effect is that the capital loss that would otherwise be sustained is reduced (or the capital gain increased, depending on the shareholder's cost base).

Tender buybacks in Australia

A relatively recent innovation in Australia is the tender buyback where the company will set a range of discrete price points at which shareholders may elect to tender all or part of their shares. The company will start at the lowest price point and work its way up until the target number of shares has been bought back. Companies also usually reserve the right to either scale back or extend the buyback (within certain predefined limits) to cover the situation where the number of shares tendered at a particular price point results in an oversubscription based on the original target.

Arguably, this tender process establishes a 'market price' for the purposes of sale, as it reflects the price at which shareholders are prepared to commit to selling their shares. This contrasts with the process for other forms of off-market buyback in which the company unilaterally fixes a price at which shares will be bought back.

The Commissioner of Taxation at first accepted the argument that the method for setting the repurchase price did not warrant the application of s. 159GZZZQ(2). However, after a handful of such buybacks had taken place, the Commissioner revised the interpretation of the law. The Commissioner issued TD 2004/22 in January 2004 over concerns that the structure of many off-market tender buybacks was driven, at least in part, by tax considerations.[13] In particular, it was argued that shares were being tendered at a discount because of the associated tax benefits.[14] The Commissioner argued that any premium or discount could be attributed to shareholders valuing the tax benefits associated with the buyback.

TD 2004/22 sets out a proxy for calculating market value for s. 159GZZZQ(2) purposes. The formula is:

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

VWAP is the volume weighted average price of the company's shares over the previous trading week and is designed to reflect more accurately the true market value of the shares by smoothing out any temporary peaks or troughs.

If shareholders value the tax benefits, then any action that reduces these benefits should lead to a change in shareholder behaviour. TD 2004/22 is designed to do this by increasing the consideration deemed to have been received for capital gains tax purposes through s. 159GZZZQ(2), and any capital loss is lessened (or any capital gain is increased) resulting in a greater amount of tax being paid, either in the current year or a future tax year.

Other things being equal, we would expect that tender buyback prices would have increased since the application of TD 2004/22 to compensate the shareholder for the loss of valuable tax benefits.

As tender buybacks are a recent phenomenon in Australia, only a small number have taken place. To investigate the share price discount or premium we divided these into buybacks that took place prior to the application of TD 2004/22 and those that took place afterwards. To maximise the data available, we considered the population of relevant tender buybacks to May 2007, rather than a sample.

The set of tender buybacks was identified from the ATO legal database,[15] which lists all class rulings. This was compared with buybacks identified in Table 5.1 of the Board of Taxation's Discussion Paper in its Review of the Taxation Treatment of Off-Market Share Buybacks.[16]

After excluding five buybacks that did not include a dividend component we were left with 24 observations which were then split into two groups, the first group comprising those buybacks that took place prior to 14 January 2004 (the date at which TD 2004/22 took effect)[17] and the second group the remainder.[18] Group 1 consists of five buybacks with the remaining 19 in Group 2. Table 1 provides details of the buybacks, including deemed market values using the methodology described in TD2004/22.

All data were obtained from the relevant class ruling, ASX disclosure documents or the Aspect Huntley financial database. Class rulings provided the date of announcement, the final repurchase price, the dividend component, capital proceeds and (for Group 2) the deemed market value as calculated under TD 2004/22.

While the Commissioner does acknowledge that other economic considerations may impact on shareholder behaviour with respect to such buybacks (including the decision to participate), the emphasis in TD 2004/22 is based on the assumption that discounting is driven by the tax benefits.

Impact of reduced tax benefits

As TD 2004/22 operates to lessen tax benefits, we would expect that prices tendered would increase to compensate shareholders for their loss of these tax benefits. To determine whether the lessening of the tax benefits has resulted in an increase in prices we used a non parametric Mann-Whitney one-tailed directional U-test.

To test the hypotheses, three tests were conducted. The discount or premium in the repurchase price for each buyback was calculated relative to:

1. The closing share price for the company on the day before the buyback was announced.
2. The closing share price for the company on the day the buyback was announced.
3. The deemed market value of the share price as calculated using the methodology in TD 2004/22.

Tests 1 and 2 were performed to control for any information effect that the announcement of the buyback itself could have on the share price. Test 3 is a more direct test of the methodology of TD 2004/22, however, the weakness of this methodology is that the calculations are based on inferred rather than observed prices.

None of the tests produced a statistically significant result at either the 5% or 1% level. This implies that there is no systematic reduction in discounts when prices at which shares are tendered after TD 2004/22 were released compared with tender prices for buybacks prior to the introduction of TD 2004/22. This finding contradicts the Commissioner's contention that shareholders had been tendering their shares at discounts to market value in part (or whole) due to the tax advantages.[19] While the Commissioner does acknowledge that other economic considerations may impact on shareholder behaviour with respect to such buybacks (including the decision to participate), the emphasis in TD 2004/22 is based on the assumption that discounting is driven by the tax benefits.

It is interesting to note that had we expected the impact of TD 2004/22 to result in a deepening of discounts, and applied a one-directional U-test accordingly, tests 2 and 3 would produce statistically significant results at the 5% level of confidence, indicating that discounts have become larger since the application of TD 2004/22. This contradicts the Commissioner's contention that the discounting prior to TD 2004/22 was tax driven, and undermines this logic as a justification for the adjustment of the deemed capital proceeds.

This result is puzzling as it suggests that shareholders do not value the tax benefits associated with off-market tender buybacks. While there are other advantages to off-market buybacks for shareholders, such as lower transaction costs (for example, no brokerage costs are incurred for shareholders selling under an off-market buyback), these other benefits are not affected by TD 2004/22. TD 2004/22

Overall, this study found little evidence that prices offered by shareholders in off-market tender buybacks are driven by tax consequences alone, contrary to the clear (also speculative) implication expressed in TD 2004/22.

only affects the tax consequences for shareholders. Other things being equal, the only change between the two groups of observations has been the tax treatment of shareholders. Given this, it is surprising to find that discounts appear to have been deepening since the tax benefits have been reduced.

While any attempt to explain this outcome will necessarily, on current theory, be speculative in nature, it is possible that the discounting is driven by general market conditions. Since TD 2004/22 has been applied until the end of the sample period, the Australian sharemarket was generally rising. It may be that the shareholders affected sold their shares at lower than market prices to liquidate their holdings, incurring fewer transaction costs and investing in other assets with the expectation that any losses sustained in participating in the buyback would be quickly recouped in the next investment. There is some general support for this theory as, with the sole exception of the Coles Myer Limited buyback in 2006, every buyback since the St.George Bank Limited buyback (announced December 2005) has been conducted at a repurchase price at the lowest price point set and has involved a very large scaleback.[20] Given that the Australian sharemarket has been declining since November 2007, the veracity of this (speculative) explanation may be susceptible to testing in the near future (once a sufficient number of off-market buybacks has taken place under these market conditions).

Overall, this study found little evidence that prices offered by shareholders in off-market tender buybacks are driven by tax consequences alone, contrary to the clear (also speculative) implication expressed in TD 2004/22.

TABLE 1: Off-market tender buybacks

ASX	Date of Announcement	Repurchase Price	Dividend	Capital proceeds	Deemed MV (TD)	Pre-announcement Close	Announcement Close
SEV	27-Aug-02	5.00	3.25	1.75	4.60	4.78	5.10
WOW	24-Feb-03	11.40	8.52	2.88	11.49	10.70	11.27
TLS	3-Oct-03	4.20	2.70	1.50	4.71	4.83	4.99
SEV	24-Oct-03	5.80	2.32	3.48	5.92	5.79	5.79
FGL	6-Nov-03	4.00	2.19	1.81	4.57	4.57	4.38
CBA	11-Feb-04	27.50	16.50	13.92	30.42	30.97	31.69
IAG	26-Feb-04	4.40	2.62	2.16	4.78	4.66	4.55
WBC	6-May-04	14.50	10.50	7.21	17.71	17.92	17.41
TLS	12-Aug-04	4.05	2.55	2.25	4.80	5.04	4.96
BHP	5-Oct-04	12.57	10.47	4.04	14.51	14.75	14.84
BSL	21-Feb-05	7.75	4.68	4.79	9.47	9.91	10.21
CXP	1-Mar-05	5.60	5.30	0.44	5.74	5.95	6.19
RIO	11-Mar-05	36.70	32.70	6.44	39.14	47.30	46.76
CML	17-Mar-05	8.30	5.30	3.84	9.14	9.85	9.66
WBC	2-Nov-05	19.13	15.13	5.18	20.31	20.58	20.51
SGB	16-Dec-05	25.69	19.15	10.59	29.74	28.40	29.15
BHP	15-Feb-06	23.45	21.35	5.96	27.31	24.16	24.35
CML	23-May-06	10.23	7.23	4.19	11.42	11.06	11.35
BHP	7-Feb-07	24.81	22.31	7.39	29.70	26.68	28.24
CXP	8-Feb-07	5.30	5.00	0.70	5.70	5.80	6.30
FGL	20-Feb-07	5.90	4.09	2.92	7.01	7.14	6.79
AWC	5-Mar-07	6.48	6.12	1.36	7.48	6.80	6.75
JST	7-Mar-07	3.90	3.80	0.15	3.95	3.79	4.15
STO	14-May-07	12.16	9.37	3.85	13.22	12.25	12.98

Notes

1 Grace Dharmawhan and Jason Mitchell 1999, 'The legislative framework of share buy-backs – a comparison of the "old" and 'existing' requirements', *University of Tasmania Law Review*, vol. 18, pp. 283–286.
2 Thomas Harris and Ian Ramsay 1995, 'An empirical investigation of Australian share buy-backs' *Australian Journal of Corporate Law*, vol. 4, pp. 393–395.
3 Asjeet Lamba and Ian Ramsay 2000, *Share buy-backs: an empirical investigation*, Centre for Corporate Law and Securities Regulation, University of Melbourne, p. 2.
4 P. Raghavendra Rau and Theo Vermaelen 2002, 'Regulation, taxes, and share repurchases in the United Kingdom', *Journal of Business* vol. 75, p. 245 and pp. 280–281.
5 David Brown 1988, 'The construction of tender offers: capital gains taxes and the free rider problem', *Journal of Business*, vol. 61, p. 183 and p. 195.
6 Anne Anderson and Edward Dyl 2004, 'Determinants of premiums on self-tender offers' *Financial Management*, vol. 33, p. 25 and p. 43.
7 Christine Brown and Katrina Efthim 2005, 'Effect of taxation on equal access share buybacks in Australia', *International Review of Finance*, vol. 5, p. 199.
8 Board of Taxation 2007, *Review of the taxation treatment of off-market share buybacks*, Discussion Paper, July, available at < http://www.taxboard.gov.au/content/downloads/Off_market_share_buybacks_DP.pdf> (accessed 8 August 2008). For more information on this inquiry, see the Board of Taxation inquiry webpage at < http://www.taxboard.gov.au/content/share_buybacks.asp> (accessed 8 August 2008).
9 Unless otherwise noted, all subsequent legislative references are to the *Income Tax Assessment Act 1936*.
10 Jason Mitchell, Grace Dharmawan and Alex Clarke 2001, 'Managements' views on share buy-backs: an Australian survey', *Accounting & Finance*, vol. 41, p. 93.
11 Section 102–15 of the ITAA 1997.
12 Division 67 of the ITAA 1997.
13 Paragraph 15.
14 ibid.
15 Law.ato.gov.au
16 Board of Taxation, above n. 9.
17 TD 2004/22 paragraph 23.
18 We excluded buybacks where the repurchase price did not include a dividend component. The Commissioner's treatment of tender buybacks was changed based on the assertion that tax advantages are maximised where part of the purchase price is divided between capital and dividend.
19 TD 2004/22 paragraph 15.
20 See relevant class ruling for each buyback.