Buybacks: What is Happening?

The recent announcement by BHP of a $5 billion off-market buyback has reignited debate about the merits of this form of capital management. Analysts are predicting a spate of forthcoming buybacks which will only serve to further fuel this debate.

Regardless of one's view on the merits of buybacks, much of the debate could have been avoided if proposed tax changes announced in 2009 had been implemented, rather than having faded into the never-never. At least one of two major changes proposed then has merit, and should be implemented asap, while the other is more contentious.

Off-market buybacks are conducted as tender offers in which the payment made by the company comprises a small amount of capital repayment with the remainder taking the form of a franked dividend. Tax rulings mean that participants in the buyback thus get substantial tax benefits from a capital loss (their purchase price less the small capital repayment component) and from dividend franking credits attached to the dividend component.

Consequently, such buybacks occur at less than the current market price of the shares, and are particularly attractive to shareholders on zero or low income tax rates (such as superannuation funds). For shareholders on high marginal tax rates, participation is not worthwhile.

This tax-based discrimination against shareholders on high tax rates has led to concerns about equitable treatment of shareholders and the consistency of such buybacks with requirements that companies should treat all shareholders equally. In effect, the argument is that valuable franking credits are being syphoned to one group of shareholders to the detriment of others.

The shortcoming of this argument is that non-participating shareholders benefit from the below-market price at which shares are repurchased from participants. Thus, both participants and non-participants benefit at the expense of the taxpayer from the realisation, rather than deferral of tax benefits available to the company and its shareholders.

This prompts two questions, answers to both of which would have been affected by the lost tax changes. First, why is there this unusual tax treatment allowing participants substantial capital losses for tax purposes? Second, are the benefits equitably shared between participating and non-participating shareholders?

One of the proposed tax changes was to remove the ability of participating shareholders to claim a tax loss for tax purposes. That would have substantially reduced the appeal of off-market buybacks and led to much lower repurchase price discounts to market price for those which occurred.

Is that an appropriate change? Arguably not. The existing tax treatment can be thought of as equivalent to a partial wind-up of the company involving return of capital (which should not be taxed) and retained earnings (and associated franking credits). But that interpretation is open to challenge and warrants greater discussion.

The second proposed change was to remove the 14 per cent maximum discount to current market price which the ATO effectively imposes on buyback prices. Almost all recent buybacks are constrained by that maximum discount, as is obvious by the substantial scaling back of applications.

Our research indicates that without the constraint the average discount would have been around 21 per cent. And non-participating shareholders would thus have been better off – because shares were bought back at lower prices.

The 14 per cent discount limit (seemingly plucked out of the air by the ATO) thus means that the distribution of the total tax benefits is biased towards participants in the buyback. And while it might seem hard to generate sympathy for policies which disfavour high tax rate investors, it is not obvious that low tax rate investors who benefit are the poor and downtrodden (rather than super funds etc).

Removing the 14 per cent discount limit thus is an obvious policy change which should be resurrected from wherever it is languishing. The other proposal (to preclude capital loss tax claims) is in a different category, and warrants further debate. Of course, if it were to be implemented, the 14 per cent limit would, because of the reduced attractiveness of buybacks, most likely become irrelevant.

With the resuscitation of corporate interests in off-market buybacks, it is important to clarify the tax arrangements sooner rather than later, and resolve debates about equitable treatment of shareholders which will otherwise resurface.

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3 March 2011