The Committee Secretary

Senate Economics Legislation Committee

submission to the
Inquiry into Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 [Provisions]

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In this submission we will focus on Schedules 4 and 5 of the Bill which deal with, respectively, alignment of the treatment of off-market buybacks with on-market buybacks and preventing franked distributions funded by capital raisings.

We have made previous submissions to the Treasury consultations on these matters and have produced a number of published opinion pieces as well. Our views on these matters are based on the results of our substantial research published in peer reviewed academic research and our knowledge of the international academic literature on corporate capital management. We have previously termed Tax-Driven-Off-Market-Buybacks as "TOMBs" and will use that terminology in this submission.

We list and provide links to our previous research, submissions to previous consultations, opinion pieces and other references at the end of this submission – most of which relate to TOMBs.

We make three main points in this submission.

The first relates to Schedule 4 of the Bill dealing with TOMBs. We believe that the changes proposed are well founded based on economic logic, principles of fair and equitable treatment of shareholders, ease and consistency of regulatory implementation, and strongly support the proposed measures. This is good legislation.

The second relates to Schedule 5 of the Bill dealing with capital raisings and franked distributions. We are of the view that there is no economic logic supporting the proposed measures, and that it would create a "grey" area in tax legislation requiring the Australian Tax Office to exercise discretion and thus involving unnecessary uncertainty for companies in their capital management activities. We are of the view that

the proposed measures are, to be blunt, silly, and not justified on the basis of possible tax avoidance activities by companies. This is bad legislation.

The third point is a more general one about the process of legislative change and lack of public availability of submissions to Treasury (or other) consultations which could inform public debate and members of Parliament. Also lacking is public explanation of how information in submissions might have led to changes in draft legislation or, as in the current case, why it appears to have been ignored.

TOMBs (Schedule 4)[1]

Schedule 4 effectively would effectively prevent companies from using Tax-driven, Off Market Buybacks (TOMBs) to stream franking credits to zero and low tax rate shareholders. As well as creating a significant loss to government tax revenue from such streaming, TOMBS involve significant shareholder inequities. Moreover, the returns of capital and payment of franked dividends involved can be achieved by more standard and equitable capital management techniques rather than these highly structured, complex transactions.

Even ignoring the significant tax gains likely, these Tax-Driven-Off-Market-Buybacks (TOMBs, as we have called them), are unfair to those shareholders who do not participate. (There have only been around sixty to date, but of immense size, by large companies). As in many situations, the gains to a few appear clear and conducive to lobbying, but the significant cost to the majority is less apparent.[2] In the case of TOMBS, the non-participating shareholders are not compensated adequately for the "streaming" of franking credits to the zero and low-tax-rate participating shareholders.

We have outlined the reasons for the inequity here.

We have also explained in an article in the Pearls and Irritations public policy journal that there is no reason as to why TOMBs should be allowed by the regulators, and that there is no apparent adequate justification for the ATO and ASIC permitting them to happen. The approval of these highly structured, artificial, financial transactions reeks of regulatory capture. In the absence of TOMBs, if a company wants

[1] Some parts of the following are extracted from our submission to the Treasury consultation.
[2] The net gains received by participants in a TOMB are at least partly illusory. While participants benefit from the shares they subscribe to the TOMB, they are generally also substantial holders of other shares in the company which are not accepted for participation, and on which they suffer a loss from the transfer of value to shares participating in the TOMB. While some very small shareholders may have all of their tendered shares accepted, the average "scaleback" (shares repurchased relative to shares offered at the final tender price) is in the order of 50-60 per cent.

to distribute excess franking credits, it can pay a special dividend. If it wants to return capital to shareholders it can do so via a normal on-market share buyback.

Somehow, in the mid-1990s, the smart money managed to get the regulators to acquiesce to allowing TOMBs with their artificial structure which streams franked dividends to a subset of lucky shareholders at the expense of other shareholders and government tax revenue.

Partly underpinning that benefit has been the determination by the ATO to allow a maximum discount of the buyback price to the current market price of fourteen per cent. Without that limitation, the actual discounts would be substantially greater. There is no clear public statement of how this fourteen per cent figure was decided upon! Were that limitation removed, but TOMBs permitted to continue, the discount to market value would be much higher, benefits to participating shareholders would be markedly reduced and non-participating shareholders less adversely affected. A cost to government tax revenue (compared to pro-rata distribution of franking credits via ordinary or special dividends) would still occur via the "streaming" of credits away from foreign shareholders to domestic residents.

One policy option (but not good policy) might be to allow TOMBs to continue but without the maximum discount limitation. The potential outcomes are difficult to determine since they depend on a number of factors. One such factor is the proposal that, as in the case of on-market buybacks, a debit will be made to the company's franking account balance (FAB). This is a complex topic which warrants detailed examination, beyond that possible here, to identify the appropriate size of debit to be applied. The legislation does not prescribe the actual size of the debit, which would be determined by regulators (presumably by the Australian Tax Office (ATO)). Since the actual debit determined by the regulators could be zero or some positive amount, the inclusion of this provision in the draft legislation (and also in legislation regarding on-market buybacks), is not a matter of legislative concern. However, there is a case for examining more closely how regulators should determine an appropriate debit. We have been unable to locate examples of debits to the FAB for on-market or off-market buybacks. Public information about those numbers would be good regulatory practice. In our published academic research (Australian Tax Forum, 2019) we demonstrate that the formula published by the ATO for debiting the franking account for the streaming of franking credits away from foreign shareholders is incorrect, which causes us to lose faith in how the debit is calculated more generally.

It should also be noted that allowing TOMBs has required the ATO to derive complex rules about the capital gains tax consequences of shares sold in a TOMB (and this would continue to be the case). And

ASIC relief has also been required to avoid the equal access provisions of the legislation to conduct a tender (rather than pro rata participation).

Another concern regarding regulatory implementation has been the inappropriate (in our view) regulatory allowance of companies being able to announce a TOMB with more than forty-five clear days until the tender finalisation date. This allows "smart money" investors to purchase shares after the announcement date for submission in the tender and to still be able to use the franking credits received from success in the tender. As a result of this and the resulting large scalebacks, considerable market distortions are created around the closing date of the TOMB, when the repurchasing company announces the size of the scaleback, and these smart money investors may need to sell off unsuccessfully tendered shares (see Au Yong, Brown and Ho, 2014).

We reiterate that the best policy option is as proposed in the legislation to remove any franked dividend component payment in off-market buybacks, which would sound the death-knell of TOMBs.

Our previous research estimated a tax cost of TOMBS exceeding $1 billion in some years (it depends on how many are done and how large they are, since it is only a small number of large companies involved). Treasury provides an estimate of $550 million per year of tax savings.

The legislation and accompanying explanatory material focuses on the tax cost to the budget. That alone warrants the legislation preventing franked dividends being part of an off-market buyback – it also makes any future buybacks more consistent with international practice. The inequitable treatment of shareholders is at least as important a reason as to why TOMBS deserve to die and be assigned to the graveyard of prohibited tax-rorts.

Capital Raisings and Franked Distributions

Schedule 5 has its origins in a statement in the 2016 MYEFO which proposed such a measure with future legislation to be backdated to that date. We note that the opposition has proposed an amendment that this schedule should be deleted, even though its genesis was under the Morrison government. We are of the view that Schedule 5 should be deleted from the proposed legislation.

Schedule 5 aims to prevent companies from paying franked dividends if they appear to be at variance with their "usual" dividend practices and are financed by near-simultaneous equity raisings. This is just silly! Companies may have undistributed franking credits due to taxes paid in the past when financial

management priorities led them to not pay dividends and instead use that cash for funding profitable investments.

Later, payment of a franked dividend may be optimal for investor relations or other reasons, but if no free cash is available, a capital raising may be required to obtain cash.

Note that such a capital raising could involve a debt or equity issue, but it is only the latter that is targeted in the proposed legislation. This reflects an apparent concern that an equity issue might be reflecting tax avoidance activities. Arguably that could be so, but there has been no public information provided of relevant examples.

Internationally it is quite common practice for companies to fund payouts with debt and/or equity issuance. For example, in the U.S. over 40% of companies that make payouts also raise capital in the same year, mostly using debt (see here). Equity issues are used less frequently to fund payouts in the U.S. because in a classical tax system the tax-deductibility of interest payments makes debt more preferable to equity finance than in an imputation tax system. Companies in other jurisdictions frequently use the capital markets to simultaneously make payouts and raise capital, and in this manner jointly manage their cash position and their preferred leverage. For example, in Asia-Pacific markets the practice of contemporaneously raising equity and paying out to shareholders is found to be in shareholders' interests (see Fairhurst and Nam, 2014).

The practicalities of the proposal are also problematic. How would the ATO determine when the prohibition should be applied – would an equity capital raising six months separate from the dividend payment be OK or not? A serious anomaly arises because debt issues are not included in the draft legislation, so presumably companies could fund the payout by borrowing and then at some later date, issue equity to retire the debt. Why put the ATO in the position of having to make such arbitrary determinations?

How would the legislation be applied to banks and other financial institutions which are continuously raising quasi-equity finance in the form of Additional Tier One and Tier 2 capital (preference shares which can convert into equity)? How about if a company made a convertible or converting debt issue which would later convert into equity? What about if a company initiated a dividend reinvestment scheme, thereby raising new equity finance to partially fund the dividend payout? What logic could be used to exempt such cases?

And the proposal to back-date application of the proposal, even though the measure had been signalled in 2016, would create all manner of administrative problems in reversing past tax positions of investors who received franked dividends from the now illegal transactions. A huge amount of angst is already apparent from the announcement of the proposal. And for a mere $10 million p.a. of tax revenue savings!

When first mooted in the 2016 MYEFO, it was suggested that such practices might involve a cost to revenue of (only) $10 million pa. This complicated piece of legislation requires the ATO to arbitrate on which of a company's interactions with the capital market to manage capital structure are allowable. By creating uncertainty it would hinder the efficiency of corporate capital market funding. To do so for such small tax revenue seems, to say the least, silly.

The Legislative Process

The process by which the proposed legislation has come to this point also warrants attention. Treasury, as is common, held consultations on draft legislation. Regarding the schedule 5 topic, the first consultation concluded on October 2022. Submissions received from the public are still not (at the date of writing – 29 March) available on the Treasury website. Likewise, submissions on the consultation on the Schedule 4 topic (Improving the integrity of off-market share buy-backs) which concluded in December 2022 are still not available.

Surely a consultation process is not just for Treasury or its masters to get feedback. Ignoring those submissions which contradict its opinion without exposing competing views to the sunlight of public debate is unacceptable. Where there are competing views between various vested interests and independent analysts, good public policy decision-making deserves public exposure of the arguments and views of those seeking to influence public policy. This is not to say that confidential submissions should not be allowed –there may be substantial matters of commercial in confidence involved. But it would be hoped that in explaining its response to submissions, the important issues raised in such submissions would be aired. We note, for example, that APRA adopts a process of providing a public response to submissions to consultations when explaining what effects those have had in affecting its draft regulatory standards.

This issue is also relevant for the process of Parliamentary scrutiny of legislation. Members and Senators (and their staff) should not be expected to make decisions on Bills based solely on Explanatory Memoranda – which naturally don't include the counter-arguments to what is being proposed. Ability to

access non-confidential submissions made in the consultation process can help determine whether lobby groups and others seeking to influence votes are simply talking their own book or reflect more widely-held opinions.

Conclusion

In our view, Section 4 (prohibiting TOMBs) warrants support, Section 5 (interfering with corporate interactions with the capital markets) warrants rejection.

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