TD 2004/22 - Income tax: for Off-Market Share Buy-Backs of listed shares, whether the buy-back price is set by tender process or not, what is the market value of the share for the purposes of subsection 159GZZZQ(2) of the Income Tax Assessment Act 1936?

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Taxation Determination

Income tax: for Off-Market Share Buy-Backs of listed shares, whether the buy-back price is set by tender process or not, what is the market value of the share for the purposes of subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936*?

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Preamble

The number, subject heading, date of effect and paragraphs 1 to 4 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

1. For off-market share buy-backs of listed company shares the market value of the share for the purposes of subsection 159GZZZQ(2) of the *Income Tax Assessment Act 1936* (ITAA 1936) at the time of the buy-back should be determined as the volume weighted average price (VWAP) of the company's share on the ASX over the last five trading days before the **first** announcement of the buy-back adjusted for the percentage change in the S&P/ASX 200 Index from the commencement of trading on the **first** announcement date (the Opening S&P/ASX 200 Index) to the close of trading on the day the buy-back closes (the Closing S&P/ASX 200 Index). That is:

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

2. The **first** announcement date will be taken to be the first time the company indicated to the market place that the buy-back was in serious contemplation. This may be earlier in time than when the company officially announces the details of the buy-back.

3. The precise calculation of the subsection 159GZZZQ(2) amount cannot be determined until all the relevant information and surrounding circumstances are known, including the final buy-back price. And the above process may need to be varied to reflect circumstances arising during the buy-back period, other than the buy-back itself, that have affected the value of the company's shares such that the S&P/ASX 200 Index adjustment is not reflective of the simulated movement in the company's share price. It may also be the case, depending on who the purchasing company is, that a more appropriate index than the S&P/ASX 200 should be used.

4. Companies wishing to vary the market value setting process set out in paragraph 1 should make representations about the rationale for a variation either prior to, or if a relevant event arises during the buy-back period, as soon as practicable after, the buy-back period has closed.

Background- Division 16K

5. Division 16K of Part III of the ITAA 1936 was enacted in 1990 to deal with changes to the *Corporations Law* that permitted companies to buy-back their own shares.

6. The Division applies where a company buys a share in itself from a shareholder. If the share is listed on the stock exchange and the purchase is made in the ordinary course of business of that stock exchange, the buy-back will be an on-market purchase. All other buy-backs are treated as off-market purchases.

7. The purchase price paid by the company to the shareholder is the amount of money and the value of other property (if any) the shareholder receives as consideration for the buy-back: section 159GZZZM of the ITAA 1936.

8. In an off-market buy-back of shares the difference between the purchase price and the part of the purchase price in respect of the buy-back which is debited against the company's share capital account is taken to be a dividend paid by the company to the seller, as a shareholder in the company out of profits derived by the company on the day the buy-back occurs: section 159GZZZP of the ITAA 1936. Franking credits may be available in respect of that dividend.

9. The balance (being the amount debited against the company's share capital account) will be taken to be a return of capital and will determine both the CGT position of the seller and, for assessable profits or deductible losses, the amount of that gain or loss: section 159GZZZQ of the ITAA 1936. That is, the consideration for CGT purposes and for shares held on revenue account is determined having regard to whether there is a 'reduction amount' for the purposes of subsection 159GZZZQ(3). Ordinarily, that amount is the part of the purchase price that is taken to be a dividend in accordance with section 159GZZZP.

10. A special rule in subsection 159GZZZQ(2) applies where the purchase price in respect of a share in an off-market share buy-back is **less** than the amount that would have been the market value of the share at the time of the buy-back if the buy-back did not occur, and was never proposed to occur. In such cases the market value of the share, at the time of the buy-back if the buy-back did not occur and was never proposed to occur, is taken to be the consideration in respect of the sale of the share. In effect, the amount of the deemed increase is taken to be a capital receipt and alters the CGT position of the seller – usually decreasing the capital loss otherwise available. Likewise, the amount of any assessable revenue gain would be increased, and any deductible loss decreased, by the difference between the actual consideration and the substituted amount.

11. The object of the special rule is to exclude the distortionary effect of the buy-back on the share's value for tax purposes by providing that the consideration the shareholder is taken to have received for tax purposes is not to be affected in any way by the share buy-back. As such, subsection 159GZZZQ(2) is an acknowledgement that the very fact of a buy-back can affect the value of the share being bought back.

12. Correspondingly, if there is a dividend component of the purchase price no adjustment is made to the purchase price in the event that it is **greater** than the market value of the share, but so much of the purchase price as exceeds the market value of the share at the time of the buy-back is unfrankable: section 159GZZZP and paragraph 202-45(c) of the *Income Tax Assessment Act 1997* (ITAA 1997). That is for the purposes of paragraph 202-45(c) the market value of the share, at the time of the buy-back if the buy-back did not take place and was never proposed to take place, is similarly calculated in accordance with the formula as set out at paragraph 1.

Explanation

13. Since Division 16K has been in the ITAA 1936 the overwhelming number of off-market buy-backs have been 'floating price' arrangements. In these cases the buy-back price has generally been determined as the volume weighted average price of the company's shares on the ASX over a certain number of trading days before the formal announcement of the buy-back, adjusted for the percentage change in the S&P/ASX 200 Index from the commencement of trading on the announcement date to the close of trading on the day the buy-back closes. Some other cases, where for example the purchase price was wholly debited to the company's share capital account, have undertaken a 'fixed' price buy-back arrangement involving a variation on this methodology – using only the volume weighted average price for a period immediately prior to the announcement time without further adjustment.

14. Recently, a new method of setting the buy-back price using a tender process has been adopted. Shareholders have been asked to nominate, within a set range, the amount of the purchase price they would accept as consideration for the buy-back. That is, in a tender process, shareholders are invited to sell some or all of their shares to the company by tendering parcels of shares at either a specified price within a specified price range, or as a final price tender. A final price tender is an offer to sell at the buy-back price, whatever it is determined to be by the tender process, after the tender period closes. Typically, the low point of the price range is set at a discount to the market price prevailing immediately before the detailed formal announcement of the tender process, while the top of the price range is set at a premium to that market price.

15. Previously the Commissioner has agreed, in some Ruling requests, with the proposition put to the Australian Taxation Office ("ATO") by the purchasing companies and their advisors, that the tender process produces a sufficiently accurate reflection of the market value of a share at the buy-back time had the buy-back never occurred such that the special rule in subsection 159GZZZQ(2) would not warrant application. However, having now seen (albeit) a small number of buy-back arrangements using the tender process method, it is clear that the assertion by the purchaser companies and their advisors is not correct. The evidence now available suggests that the tender process can either inflate or deflate the buy-back price compared to the market value of the share had the buy-back never occurred because shareholders have differing economic parameters (including their tax position) within which they exercise their judgement as to the price for which they are prepared to sell their shares. For example, some are prepared to sell at a relatively lower amount because of the value to them of the inherent tax advantages in

participating in the buy-back compared to an ordinary on-market sale of their shares. Superannuation funds, for example, are more likely to be in this position compared to individual shareholders.

16. In all the circumstances, the Commissioner can no longer accept the proposition put to the ATO that the tender process delivers an accurate reflection of what would have been the market value of the share at the time of the buy-back if the buy-back did not occur and was never proposed to occur. Whilst it may be the case that the tender price does, in fact, closely align itself with what otherwise would have been that market value it is not ***necessarily*** the case.

17. Nor is it necessarily the case that the prevailing trading price for the shares at the buy-back time should be taken as the market value determined as if the buy-back did not occur and was never proposed to occur. The number of sellers in the market will be affected, at least to some extent, by those opting to participate in the buy-back tender process.

18. Accordingly, for off-market share buy-backs of listed company shares, the market value of the share for the purposes of subsection 159GZZZQ(2) at the time of the buy-back should now be determined as set out in paragraph 1.

Example 1

19. Mr X is a resident shareholder in Ausco. He purchased his shares for $10.00 each in 2001 and is not a share trader. On 4 July 2003 Ausco announced that it intended to undertake an off-market share buy-back using a tender process. Ausco indicated that it would accept offers to buy back its shares in the range between $12.00 and $14.00. The amount to be debited against Ausco's share capital account will be $6.00. Ausco intends the balance of the purchase price to be a fully franked dividend to the extent that is possible under the tax law. The tender period closed on 28 August 2003. Assume that:

- after the tender period expired, Ausco announced that it would buy back shares for $12.00;
- the volume weighted average price over the last five trading days prior to the announcement was $13.00;
- the Opening S&P/ASX 200 Index is 3044.8 and the Closing S&P/ASX 200 Index is 3197.0; and
- the amount that would have been the market value of the share at the time of the buy-back if the buy-back did not occur and was never proposed to occur calculated according to the formula set out in paragraph 1 is $13.65.

$$\text{Market Value per Share} = \$13.00 \times 3197.0/3044.8$$
$$= \$13.65$$

20. The tax position of Mr X is determined as follows:

(i) the difference of $6.00 between the buy back price and the amount debited to share capital is a dividend: section 159GZZZP, (and is franked to the full extent possible);

(ii) $6.00 of the buy-back amount debited to share capital is [subject to subsection 159GZZZQ(2)] taken into account in determining whether Mr X has made a capital gain or a capital loss: subsections 159GZZZQ(1) and (3);

(iii) *prima facie*, Mr X has made a capital loss of $4.00 (being his purchase price of $10.00 less $6.00); but

(iv) owing to the fact that the buy back price is **less** than the market value as calculated, above **the deemed consideration** is increased to the market value ($13.65) under subsection 159GZZZQ(2); and

(v) as a consequence, Mr X's available capital loss will be reduced by $1.65 from $4.00 to $2.35 (being $10.00 less $7. 65).

Example 2

21. Assume the same facts as in Example 1 except that the purchase price is $14.00.

22. Mr X's tax position is determined as follows:

(i) as the company has debited $6.00 of the buy-back amount to share capital, the capital loss is $4.00 (being $10.00 less $6.00): section 159GZZZQ of the ITAA 1936;

(ii) the balance of the purchase price ($8.00) is a dividend: section 159GZZZP of the ITAA 1936; but

(iii) because the purchase price ($14.00) is **in excess** of the market value of the share, as calculated in example 1, for the purposes of paragraph 202-45(c) of the ITAA 1997 (being $13. 65), **the excess of $0.35**, whilst part of the dividend amount, is **unfrankable**.

Date of Effect

23. This Determination will apply to all off-market share buy-backs of listed company shares where a detailed announcement of the buy-back (including the distribution of the buy-back documents to shareholders setting out the details of the buy-back) had not occurred prior to 14 January 2004 being the release date of this Determination in draft form. This Determination also applies to arrangements where the purchasing company was formally advised of the ATO's interpretation of subsection 159GZZZQ(2), as set out in the draft Determination, prior to its issue date.

Commissioner of Taxation
30 June 2004

Previous draft:

TD 2004/D1

Subject references:

- market value
- off-market share buy-back
- tender process

Legislative references:

- ITAA 1936 Pt III Div 16K
- ITAA 1936 159GZZZM
- ITAA 1936 159GZZZP
- ITAA 1936 159GZZZQ

- ITAA 1936 159GZZZQ(1)
- ITAA 1936 159GZZZQ(2)
- ITAA 1936 159GZZZQ(3)
- ITAA 1997 202-45(c)
- TAA 1953 Pt IVAAA

ATO references
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