PS LA 2007/9 - Share buy-backs

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The Government has announced that from 7:30pm AEDST on 25 October 2022, there will no longer be a dividend component in respect of the price paid by a listed public company undertaking an off-market share buy-back. The entire buy-back price paid for the share will be treated as capital proceeds for a share held on capital account, or as the entire proceeds for a share held as trading stock or on revenue account (but not as trading stock).

Retrospective tax law changes have effect for a period before the date of enactment once the legislation is passed. See Administrative treatment of retrospective legislation.

Australian Government
Australian Taxation Office

Practice Statement Law Administration

PS LA 2007/9

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This law administration practice statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. ATO personnel, including non ongoing staff and relevant contractors, must comply with this law administration practice statement, unless doing so creates unintended consequences or is considered incorrect. Where this occurs, ATO personnel must follow their business line's escalation process.

Taxpayers can rely on this law administration practice statement to provide them with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this law administration practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

SUBJECT: **Share buy-backs**

PURPOSE: **To provide instruction and practical guidance to staff on the application of various taxation laws in connection with on-market and off-market share buy-backs**

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STATEMENT

1. This practice statement is designed to assist tax officers to resolve technical issues in connection with on-market and off-market share buy-backs.
2. Tax officers proposing to provide Administratively Binding Advice, Private Rulings or Class Rulings in connection with share buy-backs should follow this practice statement. However, nothing in this practice statement should be taken to require the exercise of a legal discretion without properly taking into account the particular facts of the case.
3. The practice statement considers most provisions likely to be encountered in the provision of advice to the purchaser company and vendor shareholders in a buy-back. Tax officers engaged in the provision of advice by way of a publicly-issued ruling (for example, Class Ruling) must also follow the rules set out in the Public Rulings Manual.
4. The practice statement provides administrative guidance on applying various taxation laws and also includes further explanations or interpretations drawn from cited case law.

BACKGROUND

5. The *Corporations Act 2001* governs what is permissible when a company buys back its shares. Division 16K of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) provides the basic consequences of a buy back for income tax purposes. However, several anti-avoidance provisions may alter those consequences.
6. Taxpayers commonly seek Private Rulings or Class Rulings in order to ensure that the Commissioner agrees that the terms of Division 16K of Part III of the ITAA 1936 apply in a particular way, that the anti-avoidance rules do not apply, or, if they do, that they also apply in a particular way.

7. The purpose of this practice statement is to indicate when a Private Ruling or Class Ruling may confidently be given that the provisions of tax law apply in a particular way, or do not apply at all.

8. For convenience of language, issuing a Private Ruling or Class Ruling in accordance with the taxpayer's application is commonly referred to as 'approving' the proposed buy-back. However, tax officers and taxpayers need to bear in mind that companies are entitled to buy-back shares in any way permitted by the *Corporations Act 2001*.

9. Furthermore, when a proposed transaction is not one that meets the requirements of this practice statement for 'approval', the practice statement does not necessarily specify the tax consequences, favourable or adverse, for that transaction, which must be considered in accordance with its particular facts, although a general indication of the likely result may be given.

Scope

10. The practice statement is divided into Statement and Explanation. Propositions contained in the practice statement are, where necessary, explained, clarified by example, supported by case law authority, or discussed.

11. This practice statement does not cover demergers (section 45B of the ITAA 1936) that satisfy the conditions of Division 125 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The dividend/capital split: off-market share buy-backs

12. The Australian Taxation Office (ATO) considers that, *prima facie*, the Average Capital Per Share methodology is the preferred methodology for determining the 'Dividend/Capital Split' in an off-market share buy-back. In the absence of exceptional circumstances, Average Capital Per Share will be applied to determine the capital component (see paragraphs 59 to 70 of this practice statement).

TD 2004/22: market value

13. The ATO considers that 'market value' in an off-market share buy-back by a listed company (comprising capital/dividend) continues to be governed by Taxation Determination TD 2004/22 (see paragraphs 43 to 58 of this practice statement).

14. TD 2004/22 does not, however, apply to off-market share buy-backs comprised of capital only which are conducted at arm's-length (see paragraph 54 of this practice statement).

The 45 Day Rule

15. The Commissioner will generally consent to a buy-back timetable that allows shares to trade ex-entitlement for three (3) clear business days after the Announcement Date and before the Record Date (see paragraphs 71 to 94 of this practice statement).

16. This period may be extended up to a maximum of seven (7) clear business days between Announcement Date and Record Date where there are strong commercial reasons requiring a longer period.

On-market share buy-backs

17. Companies undertaking on-market share buy-backs are required to debit their franking account as if the company had purchased the shares off-market: section 205-30 of the ITAA 1997, item 9 (see paragraphs 162 to 164 of this practice statement).

The anti-avoidance provisions

Section 45A

18. Section 45A of the ITAA 1936 is capable of application to share buy-backs in certain circumstances (see paragraphs 95 to 98 of this practice statement).

Section 45B

19. Section 45B of the ITAA 1936 is capable of application to share buy-backs in certain circumstances (see paragraphs 99 to 110 of this practice statement).

Section 177EA

20. Section 177EA of the ITAA 1936 is capable of application to off-market share buy-backs in certain circumstances (see paragraphs 111 to 126 of this practice statement). In particular, it will be applied to compensate the revenue for the avoided wastage of franking credits where a non-resident shareholder population exists (see Example 5 at paragraph 126 of this practice statement).

21. The Commissioner has outlined a formula under which the revenue will be compensated for the avoided wastage of franking credits (see paragraph 126 of this practice statement).

22. In relation to the exercise of the discretion in subsection 177EA(5) of the ITAA 1936:

    (a) the Commissioner will generally exercise his discretion in such a way that paragraph 177EA(5)(a) of the ITAA 1936 would be applied to cases where an acceptable level of discount in an off-market share buy-back is proposed (see paragraphs 117 to 126 of this practice statement), and

    (b) the Commissioner reserves his right to apply paragraph 177EA(5)(b) of the ITAA 1936 in cases where, *inter alia*, there is an unacceptable level of discount proposed (see paragraphs 117 to 126 of this practice statement).

Section 204-30

23. Section 204-30 of the ITAA 1997 is capable of application to off-market share buy-backs in certain circumstances. The Commissioner will generally not make a Determination pursuant to subsection 204-30(3) of the ITAA 1997 in cases where he intends exercising his discretion under section 177EA of the ITAA 1936 (see paragraphs 127 to 142 of this practice statement).

General value shifting regime: Divisions 725 and 727

24. The tax consequences for the capital component of a share buy-back may be affected by the application of Division 725 or Division 727 of the ITAA 1997. The consequences may flow from a value shift prior to the buy-back, or from a value shift under the buy-back itself. There may also be associated

consequences for interests not bought back. (see paragraphs 143 to 156 of this practice statement). As there are control thresholds for the application of the general value shifting regime (GVSR), there will not ordinarily be any consequences under the GVSR in relation to the buy-back of listed public company shares.

Distribution statement

25. The Commissioner will generally exercise a discretion to defer the time within which an approved form is to be supplied in a share buy-back (see paragraphs 168 to 171 of this practice statement).

Other share buy-back matters

26. This practice statement also includes guidance on a number of other routine matters:

    (a) *Withholding tax*: section 128B of the ITAA 1936 (see paragraph 157 of this practice statement).

    (b) *Dividends*: section 44 and subsection 6(4) of the ITAA 1936 (see paragraphs 158 to 161 of this practice statement).

    (c) *Frankable distributions*: section 202-40 of the ITAA 1997 (see paragraph 165 of this practice statement).

    (d) *Unfrankable distributions:* section 202-45 of the ITAA 1997 (see paragraphs 166 and 167 of this practice statement).

EXPLANATION

Division 16K

27. Share buy-backs are mainly governed, for taxation purposes, by Division 16K of Part III of the ITAA 1936 (Division 16K). Division 16K was enacted in 1990 to deal with changes to the Corporations Law that permitted companies to buy-back their own shares.

28. The Division applies where a company buys a share (or a non-share equity) in itself from a shareholder and cancels the share. On-market and off-market share buy-backs are defined in section 159GZZZK of the ITAA 1936. If the share is listed on a 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 for taxation purposes.

29. The purchase price paid by the company to the shareholder is the amount of money and/or the market value of any property the shareholder receives as consideration for the buy-back: section 159GZZZM of the ITAA 1936.

30. There are no income tax or capital gains tax (CGT) consequences for the company that carries out the buy-back: section 159GZZZN of the ITAA 1936. However, a company may be required to debit its franking account balance in respect of an on-market or off-market share buy-back (see paragraphs 111 to 126 and 138 of this practice statement).

31. In an on-market share buy-back, no part of the purchase price is taken to be a dividend in the hands of the seller: section 159GZZZR of the ITAA 1936. The purchase price forms the consideration or capital proceeds for the purposes of determining the seller's liability to CGT.

32. 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. This dividend is paid to the seller as a shareholder 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 this dividend.

33. In an off-market share buy-back, the consideration paid to a vendor shareholder will generally comprise a return of capital and a fully/partly/unfranked dividend. Dividends are considered at paragraphs 158 to 161 of this practice statement.

34. Section 159GZZZQ of the ITAA 1936 will determine the amount taken as consideration for the CGT position of the seller or for assessable profits or deductible losses where the seller is a share-trader.

35. Tax officers should also note the existence of off-market proposals that are entirely composed of capital (that is, no dividend attached). It is possible to conduct a capital-only off-market share buy-back: see for example Class Ruling CR 2004/32 and Class Ruling CR 2005/6. Such off-market buy-backs may have the final price set by a fixed price method or a tender process.

36. 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 (VWAP) of the company's shares on the Australian Stock Exchange (ASX) over a certain number of trading days before the formal announcement of the buy-back, adjusted for the percentage change in the Standard & Poors/Australian Stock Exchange 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 VWAP for a period immediately prior to the announcement time without further adjustment.

37. Recently, a new method of setting the buy-back price using a tender process has been adopted. This is sometimes referred to as a 'Dutch Auction'. 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.

38. A variation of this tender process involves shareholders offering to sell at various nominated levels of discount to market price. A final price tender option also exists under this method.

Is this arrangement a share buy-back?

39. Share buy-backs involve the purchase and cancellation of shares bought back by the company.

40. As a starting point, tax officers should satisfy themselves that the arrangement is a share buy-back (either on-market or off-market) and not a corporate reorganisation. The arrangement may not qualify as a buy-back in some circumstances:

- Is one dominant shareholder buying-out other shareholders?
- Is there some other change in the underlying ownership of shares in the subject business?
- Is part of the business being sold?
- Is this a transaction between shareholders?

41. The taxation consequences of any of these transactions for vendor shareholders will be very different to those attaching to an off-market share buy-back performed under Division 16K.

42. Tax officers should also examine the reasons the buy-back is being conducted. In particular, this rationale will go to the purposive tests in the anti-avoidance provisions:

- Has the company sold assets/businesses thereby providing capital excess to requirements?
- Does the company fail the objective purpose tests in section 45B and section 177D of the ITAA 1936 so as to produce a tax benefit?
- Other relevant events or reasons?

Market value: TD 2004/22

43. There are competing market forces at work in a tender process off-market share buy-back. On the one hand, companies strive to buy-back shares at the lowest possible price, often stating it is in the interests of remaining shareholders. On the other hand, the price paid for shares may not accord with the 'market value' of those shares as required by the special rule in subsection 159GZZZQ(2) of the ITAA 1936.

44. Tax officers should also note that the ATO has issued TD 2004/22 in respect of the special rule in subsection 159GZZZQ(2) of the ITAA 1936 concerning 'market value'. This will apply to listed public company shares. The TD provides a methodology that should be used to ascertain market value for taxation purposes.

45. The special rule in subsection 159GZZZQ(2) of the ITAA 1936 applies where the purchase price of a share in an off-market share buy-back is less than its market value. The rule requires that the amount of consideration that a seller is taken to have received is *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 effect, the amount of any deemed increase pursuant to the special rule is taken to be a capital receipt and alters the CGT position of the seller (usually decreasing any 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 market value amount.

46. 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) of the ITAA 1936 is an acknowledgement that the very fact of a buy-back can affect the value of the share being bought back. Companies requesting a variation to the formula in TD 2004/22 need to make out a case that their alternative formula gives a more accurate reflection of the share's market value than the approach in the Determination.

47. In other words, the actual amount received by vendor shareholders under the tender process may not accord with either the prevailing ASX price or their position under taxation law.

48. In respect of the tender process used by companies to buy-back their shares, the following matters should be noted:

    (a) under Australian corporate law, it is permissible for a company to buy-back its shares at a discount to market price in an off-market share buy-back, and

    (b) at taxation law, the ability to conduct an off-market share buy-back at a discount to market price is subject to:

    - section 45A of the ITAA 1936
    - section 45B of the ITAA 1936
    - vendor shareholders returning the full market value of any shares sold into the buy-back pursuant to subsection 159GZZZQ(2) of the ITAA 1936 as prescribed in TD 2004/22, and
    - the anti-streaming provisions of section 177EA of the ITAA 1936 and section 204-30 of the ITAA 1997 [*or the Commissioner determines that streaming has occurred and the company agrees to a debit to its franking account*] see generally paragraphs 111 to 126 and 127 to 142 of this practice statement.

    The level of discount in an off-market share buy-back conducted by means of a tender process is discussed fully at paragraphs 117 to 126 of this practice statement. Tax officers should note carefully this matter when dealing with Ruling applications.

First announcement date of share buy-back

49. As discussed in this section, TD 2004/22 considers the taxation market value of shares sold into a buy-back. As part of the calculation of an appropriate value for subsection 159GZZZQ(2) of the ITAA 1936, it is necessary to ascertain the 'first announcement date' of the buy-back. As the Determination states at paragraph 2:

    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.

50. Tax officers will need to carefully consider this question. The following examples may provide guidance in this matter:

Example 1

MegaMetal Ltd makes the following statement at its profit results announcement on 1 February:

> MegaMetal Ltd is investigating capital management initiatives of up to $1 billion. MegaMetal is currently reviewing the various means of returning capital, including the use of share buy-backs, so as to optimise value, with the exact amount and timing of any return being dependent upon market conditions.

On 1 March MegaMetal Ltd announces to the ASX an off-market share buy-back of $800 million to be conducted in April – May.

The ATO would regard 1 March as the first announcement date in this case.

Example 2

Stationery Inc. makes the following statement at its profit results announcement on 1 April:

> The Board is currently assessing capital management initiatives to reward shareholders, including an off-market share buy-back in the order of $50 million. Details will be announced once a final decision has been made.

On 1 May Stationery Inc. announces to the ASX an off-market share buy-back of up to $50 million to be conducted prior to 30 June.

The ATO would regard 1 May as the first announcement date in this case.

Example 3

The Four Pillars Bank Ltd makes the following statement at its profit results announcement on 1 November:

Capital Management

> Four Pillars Bank Ltd is still finalising the details associated with the issue of a new Tier 1 capital instrument. Four Pillars Bank is also presently considering undertaking a share buy-back in the first quarter of next year.

On 1 December Four Pillars Bank Ltd announces to the ASX an off-market share buy-back of up to $500 million to be conducted early in the new year.

The ATO would regard 1 December as the first announcement date in this case.

Example 4

The Big Emporium Ltd makes the following statement at its profit results announcement on 1 October:

> The Big Emporium Ltd is presently considering undertaking an off-market share buy-back of up to $600 million in the first quarter of next year.

On 1 December The Big Emporium Ltd announces to the ASX an off-market share buy-back of up to $600 million to be conducted early in the new year.

The ATO would regard 1 October as the first announcement date in this case. Reasons for this include:

- detail of timing
- detail on size of buy-back
- detail that it is an off-market share buy-back, and
- indication that the buy-back is in serious contemplation by the company.

Ex-Dividend Adjustment and TD 2004/22

51. For off-market share buy-backs of listed company shares, TD 2004/22 prescribes a methodology for obtaining the 'market value' of a share as required by subsection 159GZZZQ(2) of the ITAA 1936. TD 2004/22 acknowledges the possibility that a company's share price may be affected by matters other than the off-market share buy-back.

52. The most commonly encountered event in an off-market share buy-back that may give rise to an adjustment, as envisaged by the formula, is a company share being *cum-dividend* for part of the buy-back period.

53. The ATO will allow companies to adjust the market value calculation to exclude the effect of the share being *cum-dividend* at the time of the buy-back, on a pro-rata basis: See **Attachment A**.

Capital-only off-market share buy-back and TD 2004/22

54. The ATO will not apply TD 2004/22 in cases of capital-only off-market share buy-backs (refer to paragraph 35 of this practice statement) conducted at arm's-length.

Fixed price off-market share buy-back and TD 2004/22

55. Off-market share buy-backs are sometimes conducted on a fixed-price basis. That is, the company nominates a price that it intends to buy-back its shares and shareholders are invited to sell their shares to the company at that price. For the purposes of taxation law, the following matters should be noted.

56. First, the special rule in subsection 159GZZZQ(2) of the ITAA 1936 (see paragraphs 43 to 48 of this practice statement) still applies to fixed price buy-backs to determine market value: TD 2004/22.

57. Secondly, the point of calculation of an acceptable level of discount may be modified in the case of a fixed price buy-back. Normally, the acceptable level of maximum discount is measured at the closing date of the buy-back (see paragraphs 119 to 126 of this practice statement). In a fixed price buy-back, because the buy-back price is known, it may be acceptable to calculate the discount by reference to the VWAP of the shares over the five (5) days immediately following the detailed announcement of the buy-back. The announcement should contain full details of the buy-back including the capital/dividend split for this practice to be applied: see for example Class Ruling CR 2005/29 and Class Ruling CR 2005/87.

58. Thirdly, the acceptable level of maximum discount (see paragraphs 119 to 126 of this practice statement) still applies to fixed price off-market share buy-backs.

The dividend/capital 'split'

59. An essential aspect of any off-market share buy-back is the 'split' between the return of capital and dividend paid to participating shareholders. Section 159GZZZP of the ITAA 1936 prescribes that:

- 'capital' is debited against the company's share capital account, and
- the balance of the purchase price is a dividend.

The 'split' is nominated by the company. However, the ATO will have regard to the various anti-avoidance and integrity rules in the provision of written advice to the company.

60. For example, a 'split' that has too low a capital component will both stream dividends and artificially increase capital losses to vendor shareholders. Conversely, a capital component that is too high will provide or stream capital benefits at the expense of dividends. Neither of these outcomes is desirable.

61. The ATO considers that there are a number of acceptable methodologies for ascertaining the capital/dividend split, although not all have equal applicability in every case. The following discussion is designed to provide guidance to tax officers in deciding whether to accept the dividend/capital split proposed or to apply one of the various anti-avoidance provisions of the ITAA 1936. All of these methodologies have been accepted by the ATO in cases involving share buy-backs. The question becomes which is the most appropriate methodology in each case.

Methodologies

Average capital per share

62. One method used to determine the 'split' is for the company to work out its *average capital per share* (ACPS). This is obtained by dividing a company's ordinary issued capital by the number of shares on issue. The amount so derived is a reasonable estimate of any capital component of the split. The balance of any buy-back price would be a dividend. This method does overcome the dilution issue discussed at paragraph 63 of this practice statement. Another clear advantage is that ACPS gives rise to a strong presumption that sections 45A and 45B of the ITAA 1936 would not apply to the buy-back. Tax officers should examine recent financial year data as well as projected movements in the average. Evidence of recent capital injections just before a share buy-back may attract the anti-avoidance provisions. ACPS should, *prima facie*, be applied to determine the capital component in an off-market share buy-back. The other methods discussed below may have particular relevance or application in specific instances only.

Share capital/retained earnings ratio (Slice Approach)

63. Another acceptable method of determining the capital/dividend split, in an established company, is to calculate the ratio of share capital to retained earnings on a company's most recent balance sheet. It is sometimes referred to as the 'Slice Approach'. This ratio should then be reflected in any capital/dividend split proposed. This method seems to more accurately reflect splits in established companies as newer companies do not have a history of retained earnings. However, companies that conduct successive off-market share buy-back may contribute to significant dilution of share capital over time if they continue to use this method. This may require an examination for possible breaches of section 45B of the ITAA 1936. For this reason, it is preferable to use the ACPS method.

64. There may be particular circumstances where the use of the 'Slice Approach' is appropriate. For instance, a decision by a taxpayer company to sell-off a particular business and return that capital to shareholders is a case in point. Should the proceeds from that sale be comprised of both capital and profits, and the company proposed a distribution reflective of that capital/profits split, the ATO would probably consider that split more appropriate than ACPS. Any distribution should be capital and dividend proportionately to the interest of the shareholder in them.

65. There may be other instances where a 'Slice Approach' would be acceptable to the ATO. Tax officers should fully and critically examine the commercial rationale behind a buy-back proposal for these reasons.

Embedded value

66. The concept of 'embedded value' is an actuarial calculation reflecting the amount of value (usually for CGT purposes) per share in a demutualised entity. Former mutual companies that become companies limited by shares have used this method to attribute values to shares issued to former policy holders or members.

67. It is acceptable for a recently demutualised company to have a capital/dividend split that approximates the embedded value/retained earnings ratio. It will become less acceptable, to the ATO, over time to use this method.

68. It is similarly acceptable for a recently established listed company (without a history of retained earnings) to adopt such a method in setting its split. For example, a company 'spun-off' from an existing listed entity may propose the issue price as a capital amount. Once again, this amount (and method) loses its relevance over time.

Preferred ATO methodology

69. Tax officers should apply ACPS for share buy-backs unless companies can demonstrate exceptional circumstances for the use of an alternative methodology.

70. The 'split' should be tested against all aspects of the buy-back arrangement, including the tender buy-back process. In such a process, the ratios will change according to the final tender price. Arrangements presented to the ATO often take an average or mid-point share price. ATO advice will be based on the arrangement outlined in the Ruling application.

The 45 day rule

Qualified person

71. A shareholder who receives a franked dividend must be a 'qualified person' in relation to that dividend in order to be entitled to a tax offset under subsection 207-20(2) of the ITAA 1997. That requirement is set out in paragraph 207-145(1)(a) of the ITAA 1997, and applies where the shareholder receives the dividend directly. There are different provisions dealing with entities to whom franked distributions flow indirectly, for example, through a trust or partnership.

72. This practice statement does not deal with any other means by which a shareholder may become a qualified person in respect of a dividend.

73. One of the principles of the imputation system is that the benefits of franking credits should only be available to the true economic owner of shares, that is,

the person who bears the economic risks of loss involved in, and the opportunities for gain resulting from, ownership of shares.

74. A shareholder can show that they are a 'qualified person' in relation to the dividend component of the buy-back price if they satisfy both the holding period rule and the related payments rule, found in former Division 1A of Part IIIAA of the ITAA 1936.

The Holding Period Rule

75. Where a company is buying back its ordinary shares, the holding period rule in section 160APHO of the ITAA 1936 requires a shareholder to have held their shares on which a dividend has been paid for at least 45 days 'at risk' within a certain period. It is a once and for all test. That period is 90 days if the shares are preference shares (broadly, defined as shares that have a fixed dividend entitlement or are less risky than ordinary shares).

76. The period in which the shareholder must have held their shares at risk begins on the date those shares were acquired and ends 45 days (or 90 days in the case of preference shares) after the shares become ex-dividend. This is called the 'primary qualification period' in paragraph 160APHO(1)(a) of the ITAA 1936.

77. In counting the number of days that a shareholder has held the shares during the primary qualification period, one must exclude the days of acquisition and disposal, and those days where the shareholder is not 'at risk', that is, where the shareholder has materially diminished risks of loss or opportunities for gain in respect of the shares.

78. It is possible to work out the last day upon which a shareholder can acquire shares, dispose of them into the buy-back and still satisfy the holding period rule. This is done by taking the day on which the shares are disposed of into the buy-back, and counting back 45 clear days. Generally this day will be the date that the offer to sell shares is accepted by the company undertaking the buy-back.

79. For example, a company states that it will determine acceptances on 15 May 2005. Ignoring 15 May 2005 (day 135 of the year) and counting back 45 clear days, one must have acquired shares no later than 30 March 2005 (day 89 of the year) in order to be a qualified person.

80. Under subsection 160APHM(2) of the ITAA 1936, a shareholder is taken to have materially diminished risks of loss or opportunities for gain in respect of shares where they are exposed to less than 30% of those risks and opportunities. This exposure requires the 'net position' of the shareholder to be worked out, using the financial concept of a delta: section 160APHJ of the ITAA 1936.

81. The net position of each shareholder will differ according to what positions they have entered into. Derivatives such as call and put options, or futures contracts will affect the extent to which a shareholder is exposed to the risks and opportunities of share ownership. This is not an exhaustive list.

82. The many different circumstances that a shareholder may find themselves in means that a Class Ruling can only set out the taxation consequences for a participating shareholder in respect of the holding period rule. It will still be incumbent upon the shareholder to satisfy themselves that they have held their shares 'at risk'.

Effect of announcement

83. Tax officers may need to consider whether the company's announcement of the share buy-back process will result in a materially diminished risk of loss or opportunities for gain.

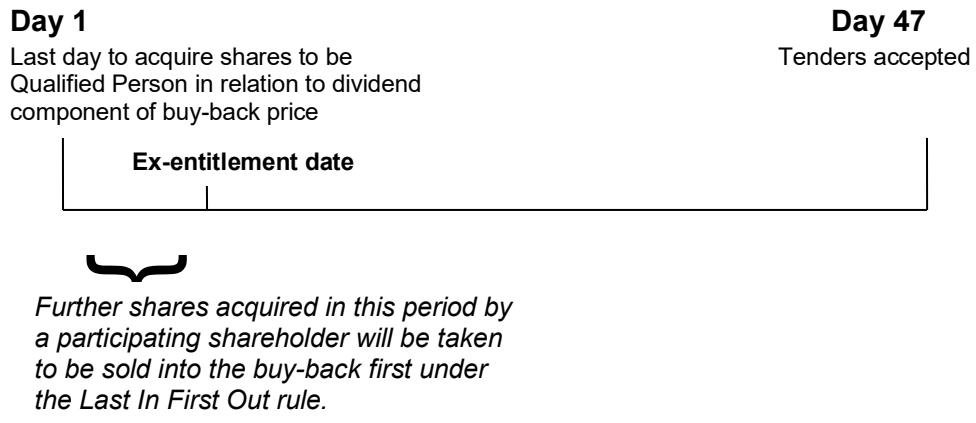
84. The Commissioner does not regard the making of a detailed announcement of a buy-back process as having an effect on whether the shares are held at risk in circumstances where the company is not under any obligation to proceed with the buy-back until acceptances are completed.

Last In First Out Rule

85. The holding period rule operates on a last-in-first-out basis, so that shareholders will be deemed to have disposed of their most recently acquired shares first for the purposes of working out whether they have held shares on which a dividend has been paid at risk for at least 45 days.

86. The Commissioner is of the view that additional shares acquired by a shareholder that do not have an entitlement to participate in the share buy-back will not be taken to have been disposed of in the share buy-back. Shares acquired on an ex-entitlement basis, that is on or after the ex-entitlement date, will not carry any entitlement to participate.

87. Therefore a shareholder who acquires additional shares after the last day upon which a person can acquire shares and still be a qualified person in relation to the dividend paid on shares sold into the buy-back, and the ex-entitlement Date, may not be entitled to some or all of the franking credit in relation to the dividends paid on some or all of their shares sold into the buy-back.



The related payments rule

88. A related payment is any arrangement whereby the taxpayer or an associate of the taxpayer passes on the benefit of a dividend or distribution to another party. Where a taxpayer, or associate, is required to make a related payment in respect of a dividend, there are more stringent rules that need to be satisfied in order to show that one is a qualified person.

89. The Commissioner cannot address in a Class Ruling the question of how the related payments rule applies because it is dependant upon the individual facts and circumstances of the shareholder, and therefore is outside the description of the arrangement.

Share buy-back timetables

90. A further policy underlying the imputation system is that imputation benefits will, over time, be spread more or less evenly across shareholders in proportion to their shareholding. The acquisition of shares in a company by an investor with the purpose of disposing of them into an announced buy-back, thereby accessing the benefits of franking credits attached to the dividend component of the buy-back price, is contrary to that policy and may attract the operation of section 177EA of the ITAA 1936.

91. Opportunities for this will be eliminated where the detailed announcement date corresponds to, or is later than, the last day that a person may acquire shares and still be a qualified person in relation to the dividend paid on shares sold into the buy-back. A share buy-back timetable structured in this way cannot be said to be facilitating the taking of a position in a company by non-shareholders in order that they may access the often abnormally large dividend component (compared to the usual pattern of distributions on ordinary dividends) and associated franking benefits.

92. To the extent that a company is a party to such a scheme through the structuring of such a timetable, it may be appropriate for the Commissioner to make a determination under paragraph 177EA(5)(a) of the ITAA 1936 that a franking debit arises in that company's franking account.

93. The ASX Listing Rules require there to be at least seven (7) clear business days between the Announcement Date of an equal access share buy-back and the Record Date. Consequently, where this minimum period is used, shares will trade ex-entitlement three (3) clear business days after the Announcement Date.

94. There may be strong commercial reasons dictating a need for a longer period between the Announcement Date and the acceptance of offers/tenders in relation to the buy-back. Where this is the case, a share buy-back timetable that caters for a maximum of seven clear business days between the Announcement Date and Record Date (consistent with the minimum requirements under ASX Listing Rules) is acceptable to the ATO.

The anti-avoidance provisions

Section 45A

95. Section 45A of the ITAA 1936 applies where a company streams the provision of capital benefits and the payment of dividends in such a way that capital benefits are received by 'advantaged shareholders' who thereby derive a greater benefit from the capital benefits than other shareholders (who receive dividends).

96. The Commissioner may make a Determination to the effect that section 45C of the ITAA 1936 applies to all or part of a capital benefit. Such a capital benefit is then deemed to be an unfranked dividend.

97. Potential capital benefits are outlined in subsection 45A(3) of the ITAA 1936. Section 45A of the ITAA 1936 does not apply if it is reasonable to assume that the disadvantaged shareholders have received (or will receive) fully franked dividends: subsection 45A(5) of the ITAA 1936.

98. The ATO will examine all arrangements for evidence of capital streaming.

Section 45B

99. Relevantly, section 45B of the ITAA 1936 applies where a 'capital benefit' is provided under a scheme for a 'more than incidental purpose' of conferring a tax benefit. Subsection 45B(5) provides that the provision of a 'capital benefit' includes a distribution of share capital. Subsection 45B(9) provides that a capital benefit constitutes a tax benefit in the hands of the shareholder because it is less onerous tax-wise than a dividend. In other words, the mischief addressed by the section is that of a company distributing capital in substitution for a dividend substantially because of its preferential tax treatment in the hands of shareholders.

100. Speaking practically, to apply section 45B of the ITAA 1936 to a share buy-back requires objective evidence of a substantial tax purpose of substituting share capital for a part of the purchase price which would otherwise be a dividend. Details of the purpose test on which section 45B turns are explained below. Before turning to the test, however, it is appropriate to discuss the character of the buy-back price in the hands of the vendor and, more particularly, whether it can include a distribution of share capital. These are issues that are resolved by Division 16K and which depend in the main on whether the share buy-back is undertaken off-market or on-market.

101. The operation of Division 16K in relation to off-market buy-backs is predicated on characterising the constitution of the purchase price in the hands of the vendor shareholder according to the manner of its debiting in the accounts of the company. To the extent that the purchase price is not debited against share capital it is taken, for the purposes of the Act, to be a dividend paid to the vendor shareholder out of profits (section 159GZZZP of the ITAA 1936). Inferentially, the balance of the purchase price, which is debited against share capital, would be taken to be a distribution of share capital. This statutory bifurcation of the price into share capital and profit displaces the character of an 'indivisible lump sum' of distribution that it would otherwise have in the hands of the shareholder under common law: *Thornett v. FCT* (1938) 59 CLR 787.

102. In regard to on-market buy-backs, Division 16K provides that no part of an on-market purchase price is a dividend (section 159GZZZR of the ITAA 1936). It also provides that, for the purposes of the Act, the whole of the purchase price is taken to be consideration for the sale of the share (section 159GZZZS of the ITAA 1936), which is not inconsistent with the common law characterisation of the purchase price as 'an indivisible lump sum' in the hands of the vendor shareholder. In the absence of Division 16K, the price of share buy-backs would similarly be statutorily bifurcated for the purposes of the Act by the definition of 'dividend' in subsection 6(1) of the ITAA 1936. However, the definition, which deems distributions to shareholders not debited against share capital to be a dividend, would not distinguish between off-market and on-market buy-backs.

103. As no part of the purchase price for an on-market buy-back of shares is received by the vendor shareholder as a dividend, from a tax perspective it is immaterial to the shareholder whether or in what proportions the company debits the purchase price to profit or share capital. On the other hand, because an off-market buy-back price preserves the character of profit and share capital in the hands of the vendor it is inherently flexible in the way it is sourced between share capital and profit. It is feasible therefore that the element of the price sourced in share capital, the receipt of which is taxed preferentially, could be inflated relative to the profit element of the price so as to enable the shareholder to gain a tax advantage. This could occur, for example, where the company has limited franking that would otherwise shelter the dividend element of the off-market buy-back price from tax in the hands of the shareholder; so the company might debit more of the purchase price to

share capital and less to profit than is defensible on grounds unrelated to tax advantage.

104. Division 16K is silent in regard to the proportions of an off-market buy-back price debited against share capital and profit. However, by definition, the purpose test in section 45B of the ITAA 1936 examines why the proportions have been chosen as they have and if the objective circumstances in subsection 45B(8) on which the test relies point to a significant tax purpose for the choice then subsection 45B(3) would authorise an adjustment.

105. The purpose of any one of the persons who entered into or carried out the scheme is sufficient to attract the operation of section 45B of the ITAA 1936. Relevant persons would include the company and its shareholders. In complex commercial transactions these persons will widely consult and rely upon professional advisers, and the 'actual parties to the scheme subjectively may not have any purpose, independent of that of a professional adviser.'[1] Where this is so, it may be appropriate to attribute the purpose of a professional adviser to one or more of the parties: *FC of T v. Consolidated Press Holdings Ltd & Anor*.[2]

106. A more than incidental purpose includes the 'main or substantial purpose' but does not need to be the most 'influential or prevailing purpose' and will not include a purpose which occurs 'fortuitously or in subordinate conjunction with one of the main or substantial purposes…or merely follows that purpose as a natural incident.'[3] A person (or persons) can be found objectively to have two or more purposes, none of which is merely incidental. In such a case, all that is necessary for section 45B of the ITAA 1936 to apply is that one of those purposes is a more than incidental purpose of obtaining a tax benefit. For example, if, objectively speaking, persons entering into or carrying out a scheme of distributing capital have a substantial purpose of obtaining a tax benefit in the form of a capital benefit, the fact that they have other purposes that are more than incidental will not prevent the section from applying.

107. The presence of the requisite 'more than incidental' purpose is to be inferred objectively from the circumstances of the arrangement. To facilitate the test and reveal the requisite purpose the section includes a non-exhaustive list of 'relevant circumstances' in subsection 45B(8) of the ITAA 1936 which must be considered in that regard. The relevant circumstances listed therein encompass a range of matters which taken individually or collectively will reveal whether the requisite purpose exists or not. Due to the diverse nature of these circumstances, some may be of little or no weight in ascertaining whether or not the purpose exists. In all cases however, tax officers must consider all of the circumstances and determine whether they tend to, against or are neutral as to the conclusion of a purpose of enabling the relevant taxpayer to obtain a tax benefit. The relevant taxpayer in a buy-back scheme is the vendor shareholder.

108. The circumstances fall into three broad categories which include: the position of the company and its associates in relation to capital and profit (realised and unrealised) and its distribution culture; the tax profiles of the shareholders; and the eight matters from paragraph 177D(b) of the ITAA 1936 that enable the wider tax and non-tax effects of the buy-back scheme to be identified, compared and weighed. The matters in paragraph 177D(b) which are relied on to determine purpose under Part IVA of the ITAA 1936 are included by virtue of paragraph 45B(8)(k) of the ITAA 1936. The Part IVA matters are to be given equal attention with the other matters included in subsection 45B(8). Indeed,

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[1] *FC of T v. Consolidated Press Holdings Ltd & Anor* (2001) 207 CLR 235; 2001 ATC 4343 at 4360; 47 ATR 229.
[2] (2001) 207 CLR 235; 2001 ATC 4343; 47 ATR 229.
[3] The Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998, at paragraphs 1.31 and 1.32.

the Explanatory Memorandum to section 45B as enacted in 1998 suggested that the Part IVA matters were the core of the purpose test and the other, more specific circumstances included to give 'further guidance' to the operation of the section.[4] So if a share buy-back has been structured for a substantial purpose of distributing share capital preferentially for tax reasons, it should be revealed from reference to circumstances in subsection 45B(8).

109. If section 45B of the ITAA 1936 is found to apply the Commissioner is empowered under subsection 45B(3) to make a determination that section 45C of the ITAA 1936 applies to the whole or a part of the capital benefit. The effect of section 45C is that the amount of the capital benefit, or part of it, is taken, for the purposes of the ITAA 1936, to be an unfranked dividend paid to the shareholder by the company out of profits. Thus, the capital benefit, or that part of it, becomes fully assessable income of the shareholder.

110. Subsection 45C(3) of the ITAA 1936 also empowers the Commissioner to make a further determination that the whole or part of the capital benefit was paid under a scheme for which a more than incidental purpose was to avoid franking debits arising in relation to the distribution. A company is required to adhere to a franking benchmark within a given period pursuant to Division 203 of the ITAA 1997. The further determination results in a class C franking debit arising, which, however, has no meaning under the new simplified imputation laws; pertinent amendments to the law have nevertheless been foreshadowed.[5]

Section 177EA

111. Section 177EA of the ITAA 1936 is a general anti-avoidance provision that applies to a wide range of schemes to obtain a tax advantage in relation to imputation benefits. In essence, it applies to schemes for the disposition of shares or an interest in shares, where a franked distribution is paid or payable in respect of the shares or an interest in shares. This would include an off-market share buy-back with a franked dividend component.

112. Specifically, subsection 177EA(3) of the ITAA 1936 provides that section 177EA applies if:

(a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and

(b) either:

(i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or

(ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of membership interests, as the case may be; and

(c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and

(d) except for this section, a person (the 'relevant taxpayer') would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and

[4] The Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998, at paragraphs 1.34 and 1.35.

[5] On 27 September 2002, the Minister for Revenue and Assistant Treasurer announced the Government's intention to introduce various consequential amendments with effect from 1 July 2002 dealing with the simplified imputation system [*Minister for Revenue and Assistant Treasurer Press Release C104/02*]. This practice statement deals only with the law as presently enacted and does not extend to the application of these proposed laws.

(e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

113. Accordingly, the issue is whether, having regard to the relevant circumstances of the scheme, it would be concluded that, on the part of a company, its shareholders or any other relevant party, there is a purpose more than merely an incidental purpose of conferring an imputation benefit under the scheme. Under this arrangement the relevant taxpayer is the participating shareholder and the scheme comprises the circumstances surrounding the buy-back.

114. In arriving at a conclusion, the Commissioner must have regard to the relevant circumstances of the scheme which include, but are not limited to, the circumstances set out in subsection 177EA(17) of the ITAA 1936. The relevant circumstances listed there encompass a range of circumstances which taken individually or collectively could indicate the requisite purpose. Due to the diverse nature of these circumstances some may not be present at any one time in any one scheme.

115. In coming to the conclusion that section 177EA of the ITAA 1936 does apply to an off-market share buy-back, the Commissioner has regard to relevant circumstances of an arrangement, as outlined in subsection 177EA(17). Tax officers should be aware of even seemingly innocuous features that have caused the provision to be applied:

- the delivery of franking credits in excess of what would have otherwise been distributed in the ordinary course of dividend declaration
- the greater attraction of the buy-back to resident shareholders who could fully utilise the franking credits than to non-resident shareholders who could not (see Example 5 at paragraph 126 of this practice statement)
- the greater attraction of the buy-back to some resident shareholders with a low marginal tax rate than other resident shareholders (for example, whereas superannuation funds are taxed at 15% and corporations at 30% individuals can be taxed at a marginal tax rate up to 45%), and
- that participating shareholders were more likely than not to make an economic gain, but a loss for taxation purposes, from their participation.

116. The ATO will challenge arrangements that cause an avoidance of 'wastage' of franking credits outside of shareholding patterns. The Explanatory Memorandum to section 177EA of the ITAA 1936 makes it patently clear that it is expected that wastage of franking credits will occur. A commonly encountered situation concerns the presence of non-residents on a company's shareholder register. A typical off-market share buy-back will stream dividends away from non-residents to residents, thus attracting the provision (see Example 5 at paragraph 126 of this practice statement).

The discretion in subsection 177EA(5)

117. Section 177EA of the ITAA 1936 is widely drafted, as an anti-avoidance provision, and invariably applies to most off-market share buy-backs. A survey of Class Rulings issued by the ATO will bear this out.

118. Where section 177EA of the ITAA 1936 applies, the Commissioner has a discretion, pursuant to subsection 177EA(5), to make a determination to debit

the company's franking account pursuant to paragraph 177EA(5)(a), or deny the imputation benefit to each shareholder pursuant to paragraph 177EA(5)(b).

119. The Commissioner will examine the proposed maximum discount level/minimum buy-back price in any off-market share buy-back arrangement. That is, the ATO will examine the tender process to ascertain the level of discount at which the company proposes to buy-back its shares.

120. The Commissioner regards the discount level as a relevant consideration in the appropriate exercise of his discretion in subsection 177EA(5) of the ITAA 1936.

121. Generally speaking, the Commissioner will exercise his discretion in such a way that paragraph 177EA(5)(a) of the ITAA 1936 would be applied to cases where there is an acceptable level of discount proposed or achieved.

122. The Commissioner may seek to apply paragraph 177EA(5)(b) of the ITAA 1936 in cases where there is an unacceptable level of discount proposed or achieved.

123. Presently, the maximum acceptable level of discount in a tender process buy-back is 14%, calculated by reference to the VWAP of the shares for the five days up to and including the closing date of the buy-back.

124. This figure may be revised from time to time. As to currently acceptable levels of discount, reference should be made to the most recent Class Rulings on off-market share buy-backs. These documents reflect the current technical views of the ATO.

125. Section 177EA of the ITAA 1936 will normally be administered by the Commissioner so as to exercise his discretion in a way that applies paragraph 177EA(5)(a). The effect of this is to debit an appropriate amount to the franking credit account of the company conducting the buy-back, to compensate the revenue for avoided wasted, or streamed, franked dividends. An example of a typical paragraph 177EA(5)(a) *Instrument of Determination* is attached as **Attachment B**.

126. An example of how the Commissioner would typically apply paragraph 177EA(5)(a) of the ITAA 1936 to debit a company's franking account, in the absence of unusual circumstances, follows this paragraph. Example 5 indicates the presence of a significant non-resident population on a company's share register.

Example 5 *NON-RESIDENTS*

MegaMetal Ltd proposes to conduct an off-market share buy-back on the following basis:

Number of shares to be bought back	30 million
Total Value	$240 million
Estimated buy-back price	$8.00
Capital Component	$2.61
Dividend Component, 100% franked	$5.39
Franking Credit	$2.31

MegaMetal Ltd has a non-resident shareholder population on its share registry of 30% (29% in tax treaty nations; 1% in non-treaty nations).

The debit would seek to capture the avoided wastage of franking credits by the streaming of dividends to resident shareholders (to whom the buy-back is

attractive) as against non-resident shareholders (to whom the buy-back is not attractive).

Typically, the Commissioner would calculate a paragraph 177EA(5)(a) debit, in the absence of unusual circumstances, in the following manner:

ATO FORMULA FOR CALCULATING THE AVOIDED WASTAGE OF FRANKING CREDITS

Number of shares bought back	x	Franking credit attaching to each	x	Non-residents	x	0.5*
= 30, 000, 000	x	$2.31	x	0.29	x	0.5
= $10, 048, 500						

* takes into account the fact that franking credit offsets withholding tax liability of 15%

Section 204-30

127. Section 204-30 of the ITAA 1997 applies where a company streams the payment of franked distributions to its shareholders in such a way that the imputation benefits attaching to the distribution are received by those shareholders who derive a greater benefit from them and other shareholders receive lesser imputation benefits, or no imputation benefits.

128. Section 204-30 of the ITAA 1997 applies where an entity streams distributions in such a way as to give those members who can benefit most from imputation credits a greater imputation benefit than those who benefit less.

129. Where section 204-30 of the ITAA 1997 applies, the Commissioner has a discretion to make one or more determinations pursuant to subsection 204-30(3).

130. The terms 'stream' and 'streaming' are not defined in the Act. However, the Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002 defines streaming as *'selectively directing the flow of franked distributions to those members who can most benefit from imputation credits'.*

131. The Explanatory Memorandum provides some guidance on the principle and features of streaming. The Commissioner's starting point is set out in paragraph 3.29:

> 3.29 It will normally be apparent on the face of an arrangement that a strategy for streaming is being implemented. The distinguishing of members on the basis of their ability to use franking benefits is a key element of streaming.
>
> 3.30 Where one class [of members] is predominantly able to use imputation credits, and the other is predominantly not, it may be apparent that an arrangement is streaming, notwithstanding the presence in each class of a small minority of the other type of member.

Broadly speaking, any strategy directing the flow of franked distributions to members who can most benefit from them to the exclusion of other members may amount to streaming.

132. The Explanatory Memorandum provides the following examples to illustrate streaming and share buy backs:

> **Example 3.2 –** Share buy-back – Limited franking surplus
>
> A corporate tax entity has members with differing abilities to benefit from franking and a limited supply of franking credits. It makes a franked distribution by buying back off-market the shares owned by taxable residents to stream the limited franking credits available to those who can most benefit from them.

This would constitute streaming. Alternatively, where there remain sufficient franking credits to frank distributions to the remaining shareholders, streaming would not occur, absent other special features.

Example 3.3 – Share buy-back – Excess credits

A corporate tax entity has excess franking credits that is, more franking credits than it is reasonably likely to use to frank its ordinary distributions. It buys back shares off-market predominantly from members most able to benefit from imputation credits because the terms of the buy-back are not attractive to the other members. As a result of the buy-back it uses profits it would not normally distribute, thereby directing a large franked distribution predominantly to those who benefit most from imputation credits.

This would be streaming. In this case avoiding wastage of franking credits is not a matter of concentrating scarce credits there may well be sufficient credits to frank distributions to other members. (This type of arrangement may result in a proportionately greater interest in the corporate tax entity being held by members less able to benefit from imputation credits, and a value shift in favour of the shares not bought back).

Application of section 204-30

133. Subsection 204-30(1) of the ITAA 1997 provides that the Commissioner has discretion to make determinations (refer to paragraph 138 of this practice statement) where an entity streams one or more distributions such that:

- an imputation benefit would be received by a member of the entity as a result of the distribution(s)
- that member would derive a greater benefit from franking credits than another member of the entity, and
- the other member will receive lesser (or nil) imputation benefits.

The streaming may take place in a single franking period or over a number of franking periods. The member that derives the greater benefit is the *favoured member*. The member that receives the lesser benefits is the *disadvantaged member*.

Meaning of 'imputation benefit'

134. For streaming to occur, a member better able to benefit from imputation credits must receive one or more imputation benefits. 'Imputation benefit' is defined in subsection 204-30(6) of the ITAA 1997 as:

- a entitlement to a tax offset or, if the member is a corporate tax entity, a franking credit
- an amount that would be included in the members assessable income as a result of the distribution because of the operation of section 207-35 of the ITAA 1997, or
- an exemption from withholding tax (relevant if the member is a non-resident).

Meaning of 'greater benefit from franking credits'

135. For section 204-30 of the ITAA 1997 to apply, members to whom distributions are streamed must derive a greater benefit from franking credits than other members.

136. Subsections 204-30(8) and 204-30(9) of the ITAA 1997 list the factors relevant in making this determination. The list is not exhaustive, but includes:

- the residency of the members (non-residents cannot fully use imputation credits)
- whether one of the members would not gain the full benefit of the tax offset from the franking credit (for example, corporate tax entities are not entitled to a refund of excess imputation credits)
- if one of the members is a corporate tax entity, whether it would not be entitled to franking credits (for example, because it is a mutual life insurance company), and
- if one of the members is a corporate tax entity, whether it would be unable to make a franked distribution to its members (and therefore would be unable to distribute the franking credits it has received).

137. A difference in marginal tax rates of members of a corporate tax entity does not, by itself, indicate that some members derive a greater benefit from franking credits than others. However, taken in conjunction with the other aspects of the share buy-back, the Commissioner may conclude that some members have derived a greater benefit from franking credits.

Effect of Commissioner's determination

138. Where section 204-30 of the ITAA 1997 applies, the Commissioner may make a determination that:

- a franking debit arises in the franking account of the streaming entity for a specific distribution made (or other benefit provided) to a disadvantaged member
- an exempting debit arises in the exempting account of the streaming entity for a specific distribution made, or other benefit provided, to a disadvantaged member, and
- no imputation benefit is to arise in respect of a specific streamed distribution made to a favoured member.

139. Subsections 204-30(4) and 204-30(5) of the ITAA 1997 explain how the debit or distribution may be specified. That is:

- the Commissioner may specify the franking percentage or exempting percentage to be used in working out the amount of the debit, or
- specify the date or period when the distribution was made, and the member or class of members to whom it was made.

140. The determination made by the Commissioner can be revoked or varied and can be made at any time after the streaming has occurred.

141. The ATO holds the view that the structure of an off-market share buy-back is a means whereby franking credits may be streamed to resident shareholders as a class, who will receive a greater benefit from franking credits than non-resident shareholders as a class.

142. The Commissioner will generally not make a Determination pursuant to subsection 204-30(3) of the ITAA 1997 in cases where he intends exercising his discretion under section 177EA of the ITAA 1936.

General value shifting regime

143. The tax outcomes for the capital component of a share buy-back may be affected by the operation of the general value shifting rules in Division 725 of the ITAA 1997 (entity interests direct value shifting) or Division 727 of the ITAA 1997 (indirect value shifting). There may also be associated consequences for shares not bought back.

144. The following explanation assumes that the shares are held on capital account. However, tax officers should be aware that the value shifting rules may also apply to interests that are characterised as revenue assets or trading stock and that there are additional consequences in those circumstances.

145. There are four (4) broad situations where, subject to threshold requirements (see paragraphs 154 and 155 of this practice statement), application of the value shifting rules may impact the tax consequences of the buy-back:

- value shift prior to a share buy-back
- off-market share buy-back at a discount – direct value shift
- off-market share buy-back at a premium – direct value shift, and
- direct value shift under a share buy-back causes an indirect value shift.

Value shift prior to a share buy-back

146. A share buy-back, for example, may form part of a broader capital restructuring of shares in a closely entity held where there is:

- a direct value shift prior to the buy-back affecting the value of interests in the entity buying back its shares, or
- an indirect value shift prior to the buy-back affecting the value of the entity buying back its shares and indirectly affecting the market value of the shares being bought back.

Direct value shift

147. If a direct value shift prior to the buy-back attracts the operation of Division 725 of the ITAA 1997 the CGT cost bases or reduced cost bases of the shares being bought back may be reset. Such resets affect the amount of the gain or loss on the capital component that subsequently arises under the buy-back.

Indirect value shift

148. If an indirect value shift to or from the entity buying back its shares occurs prior to the buy-back, Division 727 of the ITAA 1997 may operate to affect the tax outcomes under the buy-back in one of the following ways:

- Where a choice is made under section 727-550 of the ITAA 1997 to work out the value shifting consequences under the adjustable value method:
  - adjustments as at the time of the value shift are made under section 727-755 of the ITAA 1997 to the shares in the entities between which value is shifted

- these adjustments compensate (or partly compensate if the loss-focussed basis of adjustment under section 727-780 of the ITAA 1997 is adopted) for the impact of the value shift on the market values of the shares in the entities between which value is shifted, and
- as a consequence, the amount of the gain or loss on the capital component of the shares subsequently bought back is affected.

- Where a choice is not made to adopt the adjustable value method to work out the value shifting consequences and value has been shifted from the entity buying back its shares, section 727-615 of the ITAA 1997 reduces any loss on the shares bought back, to the extent that the loss is reasonably attributable to the prior value shift.

Off-market share buy-back at a discount – direct value shift

149. The buy-back of shares under an off-market buy-back for less than their market value causes value to be shifted from the shares bought back to the shares being retained. In this situation, the distortionary effect of the discount is addressed by the market value substitution rule in subsection 159GZZZQ(2) of the ITAA 1936 (see paragraphs 43 to 47 of this practice statement).

150. Subsection 725-230(2) of the ITAA 1997 provides that, where subsection 159GZZZQ(2) of the ITAA 1936 applies, the adjustable value of a down interest is not reduced and there is no taxing event generating a gain. However, subsection 725-230(3) of the ITAA 1997 may provide compensating upwards adjustments to the CGT cost bases of the retained shares.

Off-market share buy-back at a premium – direct value shift

151. The buy-back of shares under an off-market buy-back for more than their market value presents a real possibility of a direct value shift from the shares being retained to the shares that are bought back.

152. In this situation, the entity interests direct value shifting rules in Division 725 of the ITAA 1997 may apply to the holders of all the shares between which value is shifted under the share buy-back. The consequences may involve:

- downwards adjustments to the CGT cost bases of the retained shares from which value is shifted
- upwards adjustments to the CGT bases of the shares bought back (the shares to which value has been shifted), thus affecting the amount of gain or loss on the capital component under the buy-back, and
- where there are unrealised gains on the retained shares, inclusion of an assessable gain for the holders of those shares.

Direct value shift under a share buy-back causes an indirect value shift

153. Where the equity or loan interests from which value is shifted under a direct value shift are held by a company or trust, there may also be an indirect value shift out of the interests in the company or trust. The indirect value shifting rules in Division 727 of the ITAA 1997, as modified by Subdivision 727-L of the ITAA 1997, will apply to interests in the company or trust and, where an interest to which value is shifted under the direct value shift is also held by a company or trust, to interests in that company or trust.

GVSR consequences: thresholds and detailed application

154. Preliminary thresholds for identifying where the value shifting rules in Divisions 725 and 727 of the ITAA 1997 do not apply to a value shifting arrangement are:

- The transacting entities in the non-market value arrangement and the entity interests that are affected by it are not within a control or common ownership framework: see sections 725-55, 727-105 and 727-110 of the ITAA 1997. *Therefore, there would not ordinarily be any value shifting consequences for the buy-back of listed public company shares.*
- Arrangements that commence before 27 June 2002. However, in these situations, there may be consequences under the former value shifting rules in Divisions 138 and 140 of the ITAA 1997.

155. For further thresholds required to be met before there can be any consequences under the value shifting rules, see particularly:

- for direct value shifts affecting interests in companies, sections 725-50 and 725-70 of the ITAA 1997; and
- for indirect value shifts, section 727-100 of the ITAA 1997.

156. Where the value shifting rules potentially impact the taxation consequences of a share buy-back, the *Guide to the general value shifting regime* (NAT 8366), listed on the schedule of precedential ATO view documents referred to in PS LA 2003/3, will assist tax officers in working through the detail of the rules.

Other share buy-back matters

Withholding tax: section 128B

157. The share registers of many companies contain non-resident shareholders. In cases where the off-market share buy-back has a fully-franked Dividend Component, participating non-resident shareholders are not liable for Australian withholding tax under paragraph 128B(3)(ga) of the ITAA 1936.

Dividends

158. Vendor shareholders will include in their assessable income the Dividend Component under section 44 of the ITAA 1936 and an amount equal to the franking credit on the Dividend Component under subsection 207-20(1) of the ITAA 1997. Vendor shareholders will ordinarily be entitled to a tax offset equal to the amount of the franking credit of the Dividend Component pursuant to subsection 207-20(2) of the ITAA 1997.

159. Subsection 6(1) of the ITAA 1936 defines a dividend.

160. This definition is modified in some circumstances by subsection 6(4) of the ITAA 1936 which states:

> 6(4) [Limit on application of dividend]
>
> Paragraph (d) of the definition of **dividend** in subsection (1) does not apply if, under an arrangement:
>
> (a) a person pays or credits any money or gives property to the company and the company credits its share capital account with the amount of the money or the value of the property; and

(b) the company pays or credits any money, or distributes property to another person, and debits its share capital account with the amount of the money or the value of the property so paid, credited or distributed.

161. Tax officers should therefore be aware that subsection 6(4) of the ITAA 1936 can *deem* certain payments made out of a company's share capital account to be dividends in the hands of recipient shareholders where there has been an arrangement under which the company has raised share capital from certain shareholders and then uses those funds to make a distribution to other shareholders.

Section 205-30: on-market buy-backs

162. As discussed elsewhere in this practice statement, on-market buy-backs are not comprised of a dividend component. By virtue of Division 16K, they are constituted entirely of capital. However, the taxation law requires the company undertaking the on-market buy-back to make a debit to its franking account as if the company had purchased the shares off-market: section 205-30 of the ITAA 1997, item 9. Tax officers providing written advice on on-market buy-backs should familiarise themselves with section 205-30 of the ITAA 1997, of which item 9 is broadly applicable.

163. In cases where the on-market buy-back is sourced by debiting the company's share capital account only, then item 9 has no application.

164. In cases where the on-market buy-back is sourced by debiting (in full or in part) retained earnings then an item 9 debit is appropriate. The effect of item 9 is to apply section 159GZZZP of the ITAA 1936 to the on-market purchase so that any part of the purchase price not debited to the share capital account is deemed to be a dividend paid to the vendor shareholder (for the purpose of calculating the item 9 franking account debit).

Section 202-40

Frankable distributions

165. Tax officers should be aware that companies undertaking buy-backs will usually ensure that franked dividends are available to vendor shareholders. This is far more attractive to potential vendor shareholders. As well as having sufficient franking credits, a company will ensure that the dividend component of a buy-back price is franked (if possible to 100%). The legislation governing frankable distributions is contained at section 202-40 of the ITAA 1997. Quite simply, a distribution is a frankable distribution to the extent that it is not *unfrankable* under section 202-45 of the ITAA 1997 (see paragraphs 166 to 167 of this practice statement).

Section 202-45

Unfrankable distributions

166. Section 202-45 of the ITAA 1997 lists a range of unfrankable distributions which tax officers should be aware of. Of particular note is paragraph 202-45(c):

(c) where the purchase price on the buy-back of a *share by a *company from one of its *members is taken to be a dividend under section 159GZZZP of that Act – so much of that purchase price as exceeds what would be the market value (as normally understood) of the share at the time of the buy-back if the buy-back did not take place and were never proposed to take place;

167. Paragraph 202-45(c) of the ITAA 1997 covers a situation outlined in TD 2004/22 where the purchase price exceeds the market value of a share and is deemed an unfranked dividend: see paragraph 12 of TD 2004/22.

Section 202-75

Distribution statements

168. A company that pays a franked distribution has an obligation under section 202-75 of the ITAA 1997 to give the receiving shareholder a distribution statement. That statement must contain details about the distribution as set out in subsection 202-80(3) of the ITAA 1997 including details of any franking credits attached to the distribution.

169. The distribution statement must be given on or before the day on which the distribution is made: see subsection 202-75(2) of the ITAA 1997. In the context of a share buy-back, that day will be the day on which the share buy-back is completed and is ordinarily a few days after the close of the offer or tender period. The monies payable to shareholders in respect of their shares disposed of into the buy-back are usually paid soon thereafter.

170. The distribution statement must be in the approved form: see subsection 202-80(2) of the ITAA 1997. Companies are able to request the Commissioner exercise his discretion under section 388-55 of Schedule 1 to the *Taxation Administration Act 1953* to defer the time within which an approved form is required to be given to another entity.

171. Provided such a request is made prior to the day on which the distribution is made, the Commissioner will generally exercise that discretion favourably where there is not an unreasonable delay between the completion of the buy-back and the provision of the distribution statement.

Approved Methodology for Calculating the Opening VWAP for the purposes of applying the methodology in TD2004/22, adjusted for the payment of a dividend during the period of the Buy-Back

Example 7

The Trustee's Friend Pty Ltd undertook an off-market share buy-back by way of a tender process. The first announcement date of the off-market share buy-back was 6 February 2007 and the tender period closed on 12 April 2007.

The Trustee's Friend Pty Ltd paid the 2006 Interim Dividend on 28 August 2006 and the 2006 Final Dividend on 11 February 2007.

Method:

Step 1:

Determine 5-day VWAP prior to the first announcement of the off-market share buy-back	$5.00

Step 2:

2006 Final Dividend	- Face Value	$0.08
	- Total (grossed up for franking)	**$0.11**

The Buy-Back Price will be set on an ex-dividend basis, therefore the 5-day VWAP needs to be adjusted for the grossed up value of the final dividend.

Step 3:

Ex-Date for 2006 interim dividend	28 August 06
Last day for VWAP period prior to announcement date	5 February 07
Days trading cum 2006 dividend: Interim dividend ex-date to off-market share buy-back announcement date	162
Total days between Ex-dividend dates for the 2006 interim dividend and 2006 final dividend (11 February 07)	168
Days trading cum 2006 final dividend as a % of total	**96.4%**

The shares traded 162 days cum the 2006 final dividend, prior to the announcement date of 6 February 2007. As a result the 5-day VWAP is adjusted for 96.4% of the grossed up value of the dividend, which reduces the 5-day VWAP by $0.11.

Step 4:

5-day VWAP prior to first announcement of the off-market share buy-back	$5.00
Deduct apportioned FY06 final dividend ($0.11 × 96.4%)	$0.11
Implied 5-day VWAP, adjusted for interim dividend, on first announcement of the buy-back	**$4.89**

Step 5:	
Opening Level of S&P/ASX 200 Index on 6 February 2007 (announcement date)[6]	4,100.0
Closing Level of S&P/ASX 200 Index on 12 April 2007 (tender closing date)	4,150.0
Movement in S&P/ASX 200 Index over Buy-Back period	**1.22%**
Step 6:	
5-day VWAP over 5 days prior to announcement on 6 February 2007	$4.89
Movement in S&P/ASX 200 Index	1.22%
Market Value of shares as per TD 2004/22	**$4.95**

[6] must be the same as the Closing Index on 5 February 2007.

ATTACHMENT B

INCOME TAX ASSESSMENT ACT 1936

DETERMINATION UNDER PARAGRAPH 177EA(5)(a)

<Name of Company>

<ABN>

<Address for Service of Notices>

I, <Delegate>, in the exercise of the powers and functions conferred upon me as Assistant Commissioner LB&I, by delegation from the Commissioner of Taxation pursuant to section 8 of the *Taxation Administration Act 1953*, DO HEREBY DETERMINE for the purposes of paragraph 177EA(5)(a) of the *Income Tax Assessment Act 1936* ('the Act').

IN RESPECT OF <Name of Company> ('the Taxpayer') who was a party to a scheme for a disposition of shares in a company to which section 177EA applies, and who paid a franked dividend to shareholders on or about <date>.

THAT a franking debit of the Taxpayer arises in respect of the dividend paid to shareholders on or about <date>.

In accordance with the provisions of paragraph 177EA(5)(a) of the Act, I HEREBY DETERMINE that a franking debit of a total amount of <Amount in words and figures> arises in respect of the dividend.

Signed at <Place>, <Date>

……

Assistant Commissioner

LARGE BUSINESS & INTERNATIONAL

Amendment history

26 May 2014

Part	Comment
Contact officer	Updated.

2 November 2012

Part	Comment
Generally	Update to current corporate publication style.
Contact officer	Updated.

17 February 2009

Part	Comment
Business line	Updated.

Subject references	cancellation of shares dividend streaming arrangements frankable dividends franked dividends general value shifting regime holding period rule qualified person related payment rule share buy-backs withholding taxes
Legislative references	ITAA 1936 Pt IIIAA Div 1A ITAA 1936 6(1) ITAA 1936 6(4) ITAA 1936 44 ITAA 1936 45 ITAA 1936 45A ITAA 1936 45A(3) ITAA 1936 45A(5) ITAA 1936 45B ITAA 1936 45B(3) ITAA 1936 45B(5) ITAA 1936 45B(8) ITAA 1936 45B(8)(k) ITAA 1936 45B(9) ITAA 1936 45C ITAA 1936 128B ITAA 1936 128B(3)(ga) ITAA 1936 Pt III Div 16K ITAA 1936 159GZZZIA ITAA 1936 159GZZZJ ITAA 1936 159GZZZK ITAA 1936 159GZZZL ITAA 1936 159GZZZM ITAA 1936 159GZZZN ITAA 1936 159GZZZP ITAA 1936 159GZZZQ ITAA 1936 159GZZZQ(2) ITAA 1936 159GZZZR ITAA 1936 159GZZZS ITAA 1936 160APHJ ITAA 1936 160APHM ITAA 1936 160APHM(2) ITAA 1936 160APHO ITAA 1936 160APHO(1)(a) ITAA 1936 177D ITAA 1936 177D(b) ITAA 1936 177EA ITAA 1936 177EA(3) ITAA 1936 177EA(5) ITAA 1936 177EA(5)(a) ITAA 1936 177EA(5)(b) ITAA 1936 177EA(17)

	ITAA 1997 Div 125 ITAA 1997 202-40 ITAA 1997 202-45 ITAA 1997 202-45(c) ITAA 1997 202-75 ITAA 1997 202-75(2) ITAA 1997 202-80 ITAA 1997 202-80(2) ITAA 1997 202-80(3) ITAA 1997 203 ITAA 1997 204-30 ITAA 1997 204-30(1) ITAA 1997 204-30(3) ITAA 1997 204-30(4) ITAA 1997 204-30(5) ITAA 1997 204-30(6) ITAA 1997 204-30(8) ITAA 1997 204-30(9) ITAA 1997 205-30 ITAA 1997 207-20(1) ITAA 1997 207-20(2) ITAA 1997 207-35 ITAA 1997 207-145(1)(a) ITAA 1997 725-50 ITAA 1997 725-70 ITAA 1997 725-100 ITAA 1997 725-230 ITAA 1997 725-230(2) ITAA 1997 725-230(3) ITAA 1997 727-100 ITAA 1997 727-110 ITAA 1997 727-105 ITAA 1997 727-550 ITAA 1997 727-755 ITAA 1997 727-615 ITAA 1997 727-780 ITAA 1997 Subdiv 727L TAA 1953 8 TAA 1953 Sch 1 388-55
Related public rulings	TD 2004/22 CR 2005/29 CR 2005/87
Related practice statements	PS LA 2003/3 PS LA 2003/9 PS LA 2005/24
Case references	Thornett v. F. C. of T. (1938) 59 CLR 787 F.C. of T. v. Consolidated Press Holdings Ltd & Anor (2001) 207 CLR 235; 2001 ATC 4343; 47 ATR 229
Other references	Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002 Explanatory Memorandum to the Taxation Laws Amendment (Company Law Review) Bill 1998
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