THE TAX INSTITUTE

17 June 2013

Mr Matthew Brine
Manager
Corporate Tax Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Email: dividendwashing@treasury.gov.au

Dear Mr Brine

PREVENTING DIVIDEND WASHING

The Tax Institute thanks Treasury for the opportunity to make this submission in response to the Discussion Paper entitled "Preventing dividend washing" dated June, 2013 (the "**Discussion Paper**").

Overview

We agree that dividend washing (as the term is used in the Discussion Paper) threatens the integrity of our imputation system by allowing shareholders to claim two sets of franking credits on what is effectively the same parcel of shares.

We congratulate the Government on the announced intention to prevent such activity, as the operation of Australia's tax system based on voluntary compliance relies heavily on confidence in the integrity of the system.

Options to address dividend washing

As implied in the Discussion Paper, it is possible that the current general anti-avoidance rules apply to dividend washing schemes.

Nevertheless, it is our understanding that the Commissioner has not so applied the general anti-avoidance rule to such a scheme and conversely has provided specific taxpayers with private binding rulings noting that in similar circumstances section 177EA would not apply. It is also our understanding that as a consequence of the current state of affairs, dividend washing activities continue to occur in the marketplace.

Regardless of the applicability of section 177EA, we concur that the potential for trading both ex-dividend and cum-dividend ("**CD**") shares at the same time gives rise to a capacity to circumvent the 'last-in first-out' rule within the imputation system.

We acknowledge the perceived relative uncertainty of application and difficultly of identifying transactions to which the general anti-avoidance rule applies may make exclusive reliance on such rules to curb dividend washing inefficient and undesirable.

As such, we recommend the implementation of a targeted solution to address this issue, with reliance on the existing anti-avoidance rules as a supplement to address any further, as yet unforeseen integrity risk that may evolve in due course, including any future evolutions of similar market practices.

We do not consider the current section 177EA to be deficient for this purpose. However should the Government consider the current section 177EA to be deficient in protecting the integrity of the imputation system, we would be pleased to discuss the matter further.

Targeted measure

Option 3.2

It is our understanding that Option 3.2 is intended to have the effect of denying access to the associated franking credits when the same taxpayer sells ex-dividend shares then purchases CD shares in the same company during the two-day period during which CD shares can be purchased.

While we are cognisant of the benefits of such limited amendments to the current law, we recommend that the holding period rules not be altered to address dividend washing. This is because:

- As the holding period rules are to be revised and rewritten into the *Income Tax Assessment Act 1997*, amendments made for this purpose would be required to be revised as part of that rewrite. In this regard, we note the substantial lapse of time since this rewrite was announced, and recommend that the Government clarifies the priority of this project as well as the anticipated date of completion.

- The existing holding period rules have resulted in complex software and regulatory controls being developed which, broadly, have worked to the satisfaction of both the Australian Taxation Office ("**ATO**") and taxpayers for over a decade. As a result, altering those rules will be costly for taxpayers and also likely to be costly for the ATO as a consequence of the need for systems revision. Such a change also raises implementation risks and the possibility of inadvertent errors.

- The revision of the last-in first-out ("**LIFO**") rule is likely to be relatively costly. The existing LIFO rules are challenging to administer and most custodians and portfolio managers are entirely dependent upon well-established computer systems. Any change to the existing holding period rules, and in particular the LIFO rule, will require changes to these systems. Should the holding period rule be modified, and systems changes do not operate as planned in the first instance, amended assessments may be necessary adding to taxpayer and ATO costs.

Suggested solution

We recommend that a targeted solution should instead comprise of a revision of the current qualified person rules, as follows.

Section 160APHO could be revised by including the following:

> *160 APHO(5)*
>
> *A taxpayer is not a qualified person in relation to a particular dividend to the extent that the relevant shares were acquired after the ex date in relation to that dividend and substantially identical shares were disposed of in the three day period commencing on the ex date.*[N.B. Alternatively, it may be desirable to define this period with reference to the time period during which shares in that company can be sold/purchased on a CD basis, in order to minimise the need for future, minor legislative amendments.]
>
> *160APHO(6)*
>
> *Ex date is the date when a company closes its shareholder register for the purposes of determining which shareholders are entitled to receive a particular dividend.*

We suggest the amendment would apply with effect from 1 July 2013.

Such an approach should prevent dividend washing (as described in the Discussion Paper), would not require revision to software systems such as HiPortfolio and would not disturb current understanding and practice of how the holding period rules operate.

It is our view that such a rule, if implemented, should be self-executing and operate regardless of the taxpayer's subjective or objective purpose. A self-executing rule will provide much greater certainty to taxpayers, and will alleviate the need for the Commissioner to issue extensive guidance on when the rule would apply in circumstances of dividend washing.

Supplementary measure

<u>Option 3.3</u>

We do not consider the current general anti-avoidance rules (especially section 177EA of the *Income Tax Assessment Act 1936* ("**ITAA1936**")) to be deficient and in need of amendment. That is, it is our view that the current section 177EA could be applied by the Commissioner to protect the integrity of the imputation system both in the present environment as well as in response to potential future threats to the integrity of the imputation system.

This is because it is our understanding that as the current section 177EA is to be applied with reference to the matters referred to in subparagraphs 177D(b)(i) to (viii) [subsection 177EA(17)(j)], the further inclusion of a criterion to section 177EA(17) to highlight that the timing of trades is a relevant factor is superfluous and may prove confusing. This is because subsection 177D(b)(iii) already requires regard to be had to "the time at which the scheme was entered into and the length of the period during which the scheme was carried out".

A further inclusion of a criterion in relation to the timing of trades will also need to be taken into account in other non-dividend washing circumstances in which section 177EA will need to be considered. Even if such an inclusion does not actually expand the operation of section 177EA, it may still prove unnecessarily confusing.

To the extent that such an amendment to section 177EA is intended to reinforce the existing application of the section to dividend washing-transactions, such an outcome would be better achieved via rigorous application of the targeted measure and/or an education/compliance campaign by the ATO.

If the Government is of the view that the current section 177EA is insufficiently robust as a supplementary measure, we would be pleased to discuss the matter in greater detail.

Option 3.4

Similarly, it is our understanding that Option 3.4 will effectively limit the franking credits that can be accessed by taxpayers to a maximum of the franking credits attached to the dividend paid on the ex-dividend shares. It is not clear to us whether such a rule is intended to be self-executing, whether the taxpayer needs to have the requisite purpose of dividend washing or whether the Commissioner would need to make a determination to activate the rule.

It is our view that such a rule would be superfluous to section 177EA, confusing to apply and would result in a lack of clarity as to allowable taxpayer behaviours. Such a rule would also require extensive ATO guidance for little or no marginal benefit to either the ATO or taxpayers. As a result, we do not recommend the adoption of such a rule.

Flow-on effects

The implementation of a targeted solution should curb the intentional dividend washing behaviour described in the Paper.

However, as noted in the Paper, not all trading in CD markets constitutes dividend washing. It is foreseeable that in certain circumstances, taxpayers will engage in the sale of ex-dividend shares and purchase of CD shares in the same company in the period between the ex-dividend date and the record date without any intention of effectively purchasing franking credits. As such, we recommend further consideration of whether the tax consequences that result when the targeted amendment applies are intended and appropriate.

For example, a targeted amendment will likely deny franking credits in circumstances when two such trades are made by the same taxpayer entity (such as an investment fund) but by two separate fund managers who are otherwise unaware of each other's activities. The targeted amendment will also apply where taxpayers on both sides of the trade are wholly domestic.

The following tax consequences of receiving a dividend on a CD share in relation to which the franking credit is denied will need to be more fully considered to ensure the outcome is intentional and appropriate:

– Is the taxpayer required to include the full dividend in assessable income without the associated franking credit?

– Will the sale of the ex-dividend shares still be treated under the routine CGT provisions?

– Conversely, will the sale of the CD shares still be treated under the routine CGT provisions?

Furthermore, unless the chosen measure also applies to related parties, the capacity for undetected dividend washing activity will remain. Conversely, application of such a measure to all related parties risks being unnecessarily broad, and will require consideration of all of the activities of a taxpayer's related parties in order to ensure access to franking credits attached to a CD share.

* * * * *

Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

Steve Westaway
President