

---

TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING) BILL  
2022

---

EXPOSURE DRAFT EXPLANATORY MATERIALS

---

## ***Table of contents***

---

Glossary.....	1
Chapter 1      Franked distributions funded by capital raisings .....	3

---

# ***Glossary***

---

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<b><i>Abbreviation</i></b>	<b><i>Definition</i></b>
Bill	Treasury Laws Amendment (2022 Measures for a later sitting) Bill 2022
GST Act	<i>A New Tax System (Goods and Services Tax) Act 1999</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>



---

# Chapter 1

## ***Franked distributions funded by capital raisings***

---

### **Outline of chapter**

1.1 Schedule # to the Bill amends the taxation law to prevent certain distributions that are funded by capital raisings from being frankable.

### **Context of amendments**

#### ***The imputation system***

1.2 The imputation system has the effect of allowing income tax paid by Australian corporate tax entities to be taken into account when determining the taxation of their resident members on the distributed profit of the entity. When an Australian corporate tax entity distributes profits to its resident members, it can also pass on a credit for income tax it has paid. This is done by franking the distribution. Most resident members that are individuals or superannuation funds can then claim a refundable tax offset equal to the amount of the franking credit.

1.3 References in this Chapter to legislation are to the *Income Tax Assessment Act 1997* unless otherwise stated.

1.4 A *corporate tax entity* is a company, a corporate limited partnership, or a public trading trust (see section 960-115).

1.5 *Distribution* is defined in section 960-120, and generally includes:

- for a company, a dividend;
- for corporate limited partnership, a distribution to a partner in the partnership; and
- for a public trading trust, a unit trust dividend.

1.6 A franking entity is the entity that is generally entitled to frank a frankable distribution (see sections 202-5 and 202-40). However, a franking entity cannot frank a distribution if it is an unfrankable distribution under section 202-45. The object of the frankable distribution rules is to ensure that only distributions equivalent to realised profits can be franked (see section 202-35).

***The effect on a member of an entity receiving a franked or unfranked distribution***

1.7 The rules about the effect of receiving a franked distribution are in Division 207.

1.8 Broadly, Australian resident individuals, complying superannuation funds and certain trusts that directly or indirectly receive a franked distribution must include the amount of the franking credit and distribution in their assessable income and are entitled to a tax offset equal to the amount of the franking credit (see section 207-20). Other entities that received franked distributions must also gross up the amount of the distribution, but rather than directly receiving a tax offset are instead able to pass this offset to their shareholders, partners or trustees. For corporate tax entities the tax offset can be passed on as the entity receives an equivalent credit in their own franking account and for trusts and partnerships the credit is received via the rules for distributions flowing indirectly to entities).

1.9 If an entity makes a franked distribution in certain circumstances associated with tax avoidance or manipulation of the franking system, the distribution does not receive the benefits of franking (ie. it does not entitle any entity to a franking credit or to a tax offset) (see section 207-145).

1.10 If an entity is unable to frank a distribution and makes an unfranked distribution instead, the receiving entity includes the amount of the distribution in its assessable income, but it is not entitled to a tax offset.

## **Summary of new law**

1.11 Schedule # adds distributions funded by capital raising to the list of distributions that are unfrankable.

1.12 A distribution by an entity is funded by capital raising if, broadly:

- the distribution is not consistent with an established practice of the entity of making distributions of that kind on a regular basis;
- there has been an issue of equity interests in the entity or another entity; and
- it is reasonable to conclude in the circumstances that either:
  - the principal effect of the issue of any of the equity interests was to directly or indirectly fund some or all of the distribution; or

- any entity that issued or facilitated the issue of any of the equity interests did so for a purpose (other than an incidental purpose) of funding the distribution or part of the distribution.

## **Detailed explanation of new law**

1.13 Schedule # amends the ITAA 1997 to include a new item to make certain distributions funded by capital raising unfrankable. *[Schedule #, items 1 and 2, paragraph 202-45(e) and section 207-159 of the ITAA 1997]*

1.14 Direct or indirect recipients of affected distributions are not entitled to a tax offset and the amount of the franking credit is not included in the assessable income of the recipient. The distribution is also not exempt from withholding tax under section 128B of the ITAA 1936.

1.15 The amendments provide that a distribution by an entity is funded by capital raising if:

- the distribution is not consistent with an established practice of the entity of making distributions of that kind on a regular basis;
- there is an issue of equity interests in the entity; and
- it is reasonable to conclude, having regard to all relevant circumstances, that either:
  - the principal effect of the issue of any of the equity interests was to directly or indirectly fund all or part of the distribution; or
  - an entity that issued or facilitated the issue of the interests did so for a purpose of funding all or part of the distribution.

1.16 These amendments are an integrity measure. They prevent entities from manipulating the imputation system to obtain inappropriate access to franking credits. They will specifically prevent the use of artificial arrangements under which capital is raised to fund the payment of franked distributions to shareholders and enable the distribution of franking credits.

## **Established practice**

1.17 The first requirement for the amendments to apply to make a distribution unfrankable is that the distribution must not be consistent with an established practice of the entity of making distributions of that kind on a regular basis.

1.18 This requirement can be satisfied either if the entity has no established practice of making distributions of that kind, or if it does have such a practice, the distribution is not made at a time or in a manner that accords with that practice.

1.19 In determining whether an established practice of making distributions exists and what it involves, regard must be had to the nature, timing and amount of past distributions, as well as the franking credits attached to and the extent to which past distributions are franked.

1.20 In many circumstances these factors are likely to be conclusive of the existence of an established practice. For example, if an entity has paid a dividend of the same amount to the same class of shareholders at the same time each year for many years, then the entity will have a practice of making such distributions and the next annual payment on the same basis will be part of the practice. Similarly, if an entity has never previously made a distribution, then the entity will not have a practice of making distributions.

1.21 Regard must also be had to any explanation for the previous distribution put forward by the entity. This includes guidance and commitments made to markets or shareholders about those distributions in addition to public statements or statements to third parties explaining the amount, timing or commercial rationale for past distributions. This is most likely to be relevant when considering if past distributions are sufficiently connected to constitute an established practice, or in seeking to determine if changes are sufficiently significant to represent a break from established practice.

1.22 The specifically listed matters are not exhaustive. Any other relevant considerations can and should be taken into account in determining if this requirement is satisfied.

1.23 However, when considering if an established practice exists, past distributions to which the amendments apply, or to which the amendments would apply disregarding the requirement relating to past practice, must not be considered. This means that any practice involving the sort of mischief the amendments seek to prevent does not protect future distributions.

1.24 Broadly, this requirement ensures that this integrity rule does not affect ordinary distributions that have been made on a regular basis and are not made as part of artificial arrangements designed to distribute franking credits to shareholders.



## **Issue of equity interests**

1.25 The second requirement for a distribution to be unfrankable as a result of the amendments is that there must have been an issue of equity interests (i.e. a capital raising) by the entity or any other entity.

1.26 This requirement is broad. The issue of equity interests can occur before or after the distribution and the entity issuing the equity interests need not have any connection to the entity that has made the distribution. The entity issuing the equity interests also does not need to be a company for income tax purposes. However, despite its broad scope it is necessary for the other requirements to be met before the integrity rule applies.

## **Purpose or effect of the issue of equity interests**

1.27 The final requirement for a distribution to be unfrankable builds on the second requirement by providing that it must be reasonable to conclude that, having regard to all of the relevant circumstances, the issue of an equity interest or interests must have (whether directly or indirectly) either:

- had the principal effect of funding the distribution or part of a distribution; or
- been undertaken or facilitated by at least one entity for the purpose of achieving that result.

1.28 This is the key requirement that tests whether the capital raising by the issue of equity interests has funded the distribution.

1.29 The ‘purpose’ test is based on similar tests in the anti-avoidance rules in the ITAA 1936 (including in section 177EA of that Act). The principal effect test is based on the similar test in the general anti-avoidance rule in Division 165 of the GST Act.

1.30 The principal effect test is satisfied if, in all of the relevant circumstances, it is reasonable to conclude that the main or most significant consequence of the issue of equity interests was funding the making of some or all of the distributions.

1.31 If an issue of equity interests has a number of effects, one of which is directly or indirectly funding some or all of a franked distribution, then this test will only be satisfied if this was the main or leading effect of the issue of equity interests.

1.32 The purpose test is satisfied if, in all the relevant circumstances, it is reasonable to conclude the entity that issued the shares or an entity that facilitated the issue of the shares did so for a purpose of generating funds for the making of all or part of the distribution.

1.33 It is not necessary that the relevant purpose be the sole, dominant or primary purpose of the entity, only that it was more than incidental to some other purpose. Likewise it is not necessary that the purpose is a purpose of the entity that issued the equity interest. It is only necessary that an entity that was involved in facilitating or bringing about the issue of the equity interests did so with such a purpose. This ensures that, for example, the purposes of advisers and related parties can be taken into account. It ensures there are no incentives to engage in artificial arrangements on behalf of other entities.

1.34 In many cases the outcome of these tests would be expected to be the same. Generally, if equity interests are issued as part of an artificial arrangement designed to distribute franking credits, the arrangement would both be entered into for the purpose, and have the principal effect, of funding a franked distribution. The difference between the two tests is that the ‘principal effect’ test looks at the outcome, while the ‘purpose’ test looks at the intention. The inclusion of the two tests ensures the provisions apply where either the intention or effect of a capital raising is to fund a distribution.

1.35 In some circumstances entities may seek to conceal artificial arrangements by combining them with activities undertaken for legitimate purposes. For example, an entity may combine a distribution funded by capital raising with an ordinary dividend or, alternatively, issue equity interests to both raise capital for genuine commercial or regulatory purposes and to fund a distribution. To address such arrangements, the tests are satisfied not only in relation to an entire issue of equity interests or franked distribution, but also in relation to any of the capital raised from an issue of equity interests or any part of a distribution.

1.36 Even if the test is satisfied only in relation to some of the capital raised from an issue of equity interests or part of a franked distribution, the entire distribution ceases to be able to be franked.

***Considerations in determining purpose and effect***

1.37 Schedule # identifies a number of matters that must be taken into account when determining the principal effect of the issue of equity interests or the purpose of an entity involved in an issue of equity interests.

1.38 These matters include the time or times at which the equity interests were issued relative to the time of the franked distribution, the amount of the distribution, and any other distributions made before or after the franked distribution by the same entity.

1.39 These matters are unlikely to be determinative – merely delaying a distribution or capital raising, or raising a different amount will not prevent a distribution being funded or partly funded by a capital raising

where other factors make clear it was undertaken for this purpose or has had this effect. However, alignment between the timing or amount is a matter that supports the existence of the required purpose or effect. Likewise, the making of other distributions may provide important context in evaluating the purpose or effect of the distribution in question.

1.40 The matters also include the extent to which, following the issue of equity interests and making of the distributions, there has been a net change in the financial position of the entity making the distribution and any related parties.

1.41 If there has been no substantial net change in the financial position of the entity following the distribution of franking credits, then this strongly supports the conclusion that the purpose and effect of the issue of equity interests was to fund the distribution. On the other hand, if the issue of equity interests and the distribution both took place in the context of a sale or acquisition of a significant part of the business carried on by an entity, then a closer examination of the facts and circumstances would be required.

1.42 The matters to be considered also include the use of the funds raised by the issue of equity interests and the reasons for the issue of equity interests. Having regard to these matters ensures that the context surrounding the issue of equities is taken into account.

1.43 How the funds raised are used will often be significant in determining the purpose and effect of the issue of equities. In cases where the funds raised are used to make a distribution, it would be very unlikely that the purpose and effect of the issue would not be to fund the distribution. However, the immediate use of the funds will not always matter. Even if all of the funds raised by an issue of equity interests are quarantined and used for a specific purpose, this may serve to free other funds to be distributed that would otherwise have been required to be used for that purpose. In such cases both the purpose and effect of the transaction may well be to fund the distribution.

1.44 Similarly, the reasons for the issue of equity interests will also often be significant, particularly when determining the purpose of an entity involved in an issue of equity interests. Where there are clear commercial reasons for issuing equity that explain the features and manner of the issue, then it is not likely that the purpose of the issue is to fund a franked distribution.

1.45 Finally, the matters include the extent to which the distribution is underwritten.

1.46 The extent and nature of underwriting arrangements for an issue of equity interests is an important indication of whether the capital raised from the issue is guaranteed, which may inform its purpose and effect.

1.47 The specifically listed matters are not exhaustive. Any other relevant considerations must also be taken into account in determining if the requirement is satisfied.

1.48 In some cases these factors may apply differently in relation to certain capital raised from an issue of equity interests or a specific part a distribution. As discussed above, a distribution will be unfrankable even if only part of the distribution is funded by amounts raised from an issue of equity interests. It is likewise not relevant if the equity interests are issued together with other equity interests without the same purpose or effect.

## Minor and consequential amendments

1.49 Schedule # also makes minor technical amendments to related provisions in the ITAA 1997.

1.50 Specifically, Schedule # amends paragraph 202-45(c) of the ITAA 1997 to clarify that the reference to ‘that Act’ in that paragraph, and subsequently in paragraphs 202-45(g) and (h), is a reference to the ITAA 1936. While these provisions have always referred to the ITAA 1936 the repeal of other paragraphs in section 202-45 of the ITAA 1997 resulted in this becoming hard to determine on the face of the provision.

*[Schedule #, item 4, paragraph 202-45(c) of the ITAA 1997]*

1.51 Schedule # also amends the provisions in section 820-930 of the ITAA 1997 that modify the definition of ‘equity interest’ to make clear that those modifications apply for the purpose of the other amendments made by Schedule #. The modifications made by section 820-930 broadly extend the concept of equity interest to include interests in trusts and partnerships. Making clear that these modifications apply for the purpose of these amendments ensures that they can apply to capital raisings by trusts or partnerships that fund a distribution by a related company.

*[Schedule #, item 5, subsection 820-930(1) of the ITAA 1997]*

## Application and transitional provisions

1.52 Schedule # to the Bill commences on the day after the Bill receives Royal Assent.

1.53 The substantive amendments made by Schedule # apply to distributions made on or after 12 pm, by legal time in the Australian Capital Territory, on 19 December 2016.

*[Schedule #, item 3(1)]*

1.54 In addition to the existing period of review, the Commissioner may also amend assessments made before the commencement of these amendments within 12 months after the amendments in this Bill have

commenced to give effect to the amendments made by this Schedule but only for distributions made on or after 12 pm, by legal time in the Australian Capital Territory, on 19 December 2016.

***[Schedule #, item 3(2)]***

1.55 The amendments apply retrospectively, in line with the announcement in the Government's 2016-17 Mid-Year Economic and Fiscal Outlook. This adversely affects those entities that have made or received affected distributions, contrary to this announcement.

1.56 This is necessary because the measures prevent artificial and contrived arrangements set up to inappropriately access franking credits that were not intended under the imputation system. Allowing such activity to continue between announcement and the passage of legislation without any consequences under the law would encourage their use during this period.

1.57 Further, the retrospective application and the specific date of effect were made clear in the announcement in the 2016-17 Mid-Year Economic and Fiscal Outlook.