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Franked distributions and capital raising

1. The proposed legislation on this issue is misguided and addresses the wrong problem. It also unnecessarily complicates tax legislation via the discretion given to the ATO to determine when franking of dividends involved is to be disallowed. It is not the (near) simultaneous raising of equity to finance a distribution to shareholders which is the problem. It is the streaming of dividends which should be the issue of concern.
2. A much simpler solution to the problem of preventing streaming of franking credits (with its inherent cost to government tax revenue) would be to abolish the ability of companies to undertake what we have called TOMBS (Tax-driven Off Market Buybacks). Companies wishing to make returns of capital (one component of TOMBS) would still be able to do so via buybacks where the amount involved is treated solely as a return of capital. Companies wishing to pay franked dividends which would reduce their franking account balances (FABs) would be able to do so by way of a special franked dividend paid pro-rata to all shareholders. There is nothing inherently wrong with raising cash needed to do so by issuing new equity. Under the imputation tax system, company tax paid is meant to be a pre-payment of investor level tax, and unused franking credits in a company's FAB are a withholding of tax credits due to shareholders.
3. The original ATO Taxpayer Alert ([TA 2015/2](#)) from which this proposed legislation stems, posed the problem as being the linking of an equity capital raising with "[a]t a similar time ..., the company makes franked distributions to its shareholders, in a similar amount to the amount of capital raised. This may occur as a special dividend or through an off-market buy-back of shares, where the dividend forms part of the purchase price of the shares." The ATO forecast that implementing a ban on these practices (as proposed in the draft legislation) would result in a saving to tax revenue in the order of \$10 million p.a.

4. This is a trivial amount compared to the cost to tax revenue arising from the use of TOMBS. In our research¹ on TOMBS we estimated that in 2018 the tax revenue cost from TOMBS conducted in that year alone to be in the order of \$2 billion. Recent calculations we have made for the years 2019 and 2020 (years which had many fewer TOMBS, partly due to the COVID pandemic in 2020) suggest that the tax cost for those two years together was in the order of \$500 million. These costs arise regardless of whether or not the company needs to undertake an equity issue to finance the cash outflow involved – indicating that the focus of the legislation on the “near simultaneous” equity raising is addressing a trivial, rather than the real, problem.
5. The ATO Taxpayer Alert also refers to concerns over special franked dividends where the cash outflow is essentially financed by a cash inflow from a separate equity raising. This is misguided. For example, a company may have a positive franking account balance, be legally able to pay a dividend, but not have cash on hand. There is nothing inherently wrong with raising cash via an equity issue to pay a franked dividend. For example, the company may have had a period during which it was profitable and paying tax, but adopting a low dividend payout ratio due to opportunities to profitably invest the available cash flow. Subsequently it may find itself in a position where it is profitable and “asset rich” but “cash poor” and wishing to reward existing shareholders for forgoing past dividends and associated franking credits. There is nothing inherently wrong with raising cash via an equity issue to pay a franked special dividend.
6. We conclude that the proposed legislation is inferior to an alternative course of action which:
 - a. Effectively bans TOMBS by legislating that off-market share buybacks involve only a return of capital and no dividend component. (This is more consistent with practices found in other jurisdictions. The inclusion of a dividend component is solely an artifact of dividend imputation and willingness of the ATO to allow a franked dividend component).
 - b. Does not place unnecessary restrictions on the use of special franked dividends by companies – particularly by not precluding simultaneous equity raisings.
7. Hence, we argue that the draft legislation should not proceed and the authorities should consider the alternative approach outlined in the preceding paragraph.

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¹ Christine Brown and Kevin Davis “Tax-driven Off Market Buybacks (TOMBS): Time to Lay them to Rest” *Australian Tax Forum*, 35, 2, Jun 2020: 232-257.