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Dear Sir/Madam

Franked distributions and capital raising

Deloitte appreciates the opportunity to comment upon the exposure draft legislation and draft explanatory materials (EM) in respect of **Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings**.

We submit that:

- Greater clarity is required to articulate the perceived problem, and hence the policy objective;
- The measure should be narrowed so as to focus on the particular mischief of concern, without unduly creating uncertainty for distributions generally;
- The measure as proposed creates significant uncertainties and potential impacts which may be felt across hundreds of companies, in respect of thousands of dividends which have previously been paid to millions of shareholders (some of whom may now be deceased), and who may be resident or non-resident; and
- The retrospective operation, if retained, should be narrowed so as to ensure that only particular transactions of concern are at risk of retrospective application of the measure

1 Policy objective

With respect, it is not clear to us exactly what the perceived mischief is and hence what the proposed measure should be targeting.

Section 201-1(1) sets out the main object of the franking provisions which is to "allow certain corporate tax entities to pass to their members the benefit of having paid income tax on the profits underlying certain distributions."

The other objects (principally about integrity) as set out in section 201-1(2) are that:

(a) the imputation system is not used to give the benefit of income tax paid by a corporate tax entity to members who do not have a sufficient economic interest in the entity
(b) The imputation system is not used to prefer some members over others when passing on the benefits of having paid income tax
(c) The membership of a corporate entity is not manipulated to create either of the outcomes mentioned in paragraphs (a) and (b).

There are already a range of integrity measures to support those objectives and concerns. Further, the transactions targeted by the proposed measure will in many cases (or indeed most cases given the breadth of the proposed measure) not involve either of the concerns as set out in section 201-1(2)(a) or (b).

The EM also states that "The object of the frankable distribution rules is to ensure that only distributions equivalent to realised profits can be franked (see section 202-35)". It is submitted that the transactions targeted by the proposed measure do not undermine that objective.

Indeed the measure can apply to a company which has sufficient profits to validly declare a dividend, has sufficient franking credits to validly declare the dividend to be fully franked, and pays the dividend to longstanding shareholders. In those circumstances, it is not clear what the mischief is in circumstances where the payment of that dividend is connected in some way with a capital raising.

The Joint Opinion from A H Slater and J O Hmelnitsky, 29 November 2011 provided to the ATO in respect of *Payment and Franking of dividends (Corporations Amendment (Corporate Reporting Reform) Act 2010)* is helpful (in particular, pages 21-23) in distinguishing the ability of a company to declare a dividend (dependent upon profits) and the way in which the company pays the dividend to its shareholders.

Counsel considered that the questions that were posed in that particular process "reveals a fundamental misconception of the process of declaring and paying a dividend". The Opinion steps through the two-step process of firstly, declaring a dividend and second, paying the dividend, which is reflected in the two separate accounting entries required under "the operation of the double entry bookkeeping system".

- **Declaring a dividend**: "A dividend is an appropriation of profits … Lindley LJ said that 'a dividend presupposes a profit in some shape' …", and in terms of accounting, "the debit is to an equity account: a fund of profits, possibly a reserve fund, or a provision for payment itself created by posting a debit to a profits account. A dividend can neither be appropriated from, nor debited to, an asset account"; and separately
- **Paying a dividend**: having so declared a dividend, there is then the separate matter of payment of a dividend which may occur "for example, by bank transfer or delivery of a cheque" and (usually although not always) "involves the disposal of an asset of the company, usually part of the balance of a bank current account". This involves a "credit posted to the asset account".

That is, it is necessary that there are permitted sources of profits to enable the dividend declaration, followed by payment of the dividend. The essential feature and concern of the proposed amendments is that a "distribution by an entity is funded by capital raising". Importantly however this capital raising only goes to the way in which the dividend is paid. Irrespective of how the company obtains funds in order for the dividend to be paid (whether by way of available cash reserves, borrowings, asset sales, capital raisings, etc), there must first and foremost be profits from which the dividend can be declared.

We submit that if there are profits from which the dividend can be declared, there are sufficient franking credits so that the dividend can be franked and the existing integrity rules are not applicable, that should be sufficient to permit a frankable distribution, irrespective of how the dividend is funded or paid.

Having referred to the object of the frankable distribution rules (see section 202-35), the EM goes on to say that:

- "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".
- "the measures prevent **artificial and contrived arrangements** set up to **inappropriately access** franking credits that were **not intended** under the imputation system"

The EM also draws a distinction between "ordinary distributions that have been made on a regular basis" and distributions "made as part of artificial arrangements designed to distribute franking credits to shareholders" (paragraph 1.24).

With respect it is not clear as to the difference between an ordinary distribution versus a non-ordinary distribution, and what gives rise to concerns of artificial, contrived, inappropriate, manipulation, etc in cases where the company is able to validly declare a dividend, which for tax purposes is a franked dividend.

We submit that the EM when finalised contains examples to better delineate those arrangements that are in scope and those which are not.

None of the above is to say that there may not be valid concerns about manipulation, artificial and contrived arrangements, etc in particular cases. We proceed on the basis that the release of Taxpayer Alert TA 2015/2 reflects that there were particular concerns held by the ATO in particular cases. However, we submit that any response should be targeted so as to precisely address those particular concerns and not operate more broadly.

2 Targeting the proposed measure

We submit that the scope of the proposed measure is beyond that which was previously indicated, and generally is so broad as to raise concerns in respect of ordinary dividend arrangements.

We note that TA 2015/2 variously described the arrangements under review as involving capital raisings "through issuing renounceable rights to shareholders", involving "off-market buyback of shares … [under which shareholders] may also get improved capital gains tax outcomes" and situations where "shareholders may have a choice as to whether to participate (for example, in a buy back scenario)." It is submitted that none of those features mentioned above are requisite elements in the proposed measures.

In the original 2016/17 MYEFO announcement, the Government includes specific cross referencing to the particular arrangements as outlined in TA 2015/2. The MYEFO announcement stated that "Examples of capital raising activities include an underwritten dividend reinvestment plan, a placement or an underwritten rights issue". Again, it is submitted that neither of those features mentioned in the MYEFO announcement are requisite elements in the proposed measures.

Further, the MYEFO announcement indicated a very small revenue impact ($10 million per annum) associated with the scope of the measure as then contemplated. As an indicator of the narrow focus of the MYEFO announcement, a single fully franked dividend of approximately $33 million would attach $10 million of franking credits. By contrast, the Australian Financial Review has reported that "Australian companies are on track to pay out more than $100 billion in dividends in the 2023 financial year"[1].

We submit that the breadth of the proposed measures is such that the potential impact, going back to the proposed effective date, is levels of magnitude greater than the expected revenue impact of the original announcement.

We note also the ATO comments as at November 2021, per the [2019-20 Findings report on the Reportable tax position schedule Category C disclosures] (extract below).

Relevantly, the reportable tax position schedule, section C, Question 2 asked the following:

- Did your entity fund a special dividend or a share buy-back through an equity raising event at a similar time, where the arrangement is a type of arrangement or variation of an arrangement described in Taxpayer Alert TA 2015/2?

The ATO findings report response was as follows:

- "There were **no disclosures** at question 2 in 2019–20. Question 2 relates to equity raising to fund special dividend or share buyback arrangements.
- We have continued to monitor the risk associated with arrangements described in Taxpayer Alert TA 2015/2. Our risk identification processes and assurance programs have confirmed **these arrangements are no longer prevalent** in the large public and multinational business population. This gives us confidence **we don't have a non-disclosure risk."**

This indicates that the ATO assessment is that the risk is small, and in that case, the measures should be narrowly targeted.

3 Retrospective application

We acknowledge that the MYEFO announcement was stated to be effective from 19 December 2016, that the measure remained as an announced but unenacted measure (ABUM) during the remainder of the term of the former Government, and that the current Government has shortly after its election promptly issued the exposure draft on the proposed measure. However we submit that the proposed measure is unacceptably retrospective on the following bases:

- The passage of approximately six years, with no further Government updates since the announcement in 2016.

- The ATO messaging to the large market in November 2021

- Senate standing orders - Procedural orders and resolutions of the Senate of continuing effect No. 45. which provides that "*Where the government has announced, by press release, its intention to introduce a bill to amend taxation law, and that bill has not been introduced into the Parliament or made available by way of publication of a draft bill within 6 calendar months after the date of that announcement, the Senate shall, subject to any further*

[1] Top flight earnings season sets up $102 billion windfall https://www.afr.com/markets/equity-markets/top-flight-earnings-season-sets-up-102b-dividend-windfall-20220823-p5bc2w

resolution, amend the bill to provide that the commencement date of the bill shall be a date that is no earlier than either the date of introduction of the bill into the Parliament or the date of publication of the draft bill."

- The extremely broad scope of the provisions relative to the narrower scope of scheme indicators in the TA and the MYEFO announcement
- The potential impact on a vast number of shareholders, whether individuals (some of whom may now be deceased), companies and superannuation funds, where those shareholders may be resident or non-resident.

4 Observations on the exposure draft

Our more specific comments on the draft legislation are below.

Regular practice

The condition in section 207-159(1)(a)(i) tests "whether the entity has a **practice** of making distributions of that kind on a **regular basis**" and if so, whether the relevant distribution is "**made in accordance with that practice**."

This necessarily requires both the articulation of the relevant "practice", and the testing of whether the relevant distribution is "in accordance with" that practice. Both of these elements create great uncertainty: it is not clear how widely or narrowly the relevant practice is to be defined, and it is not clear as to the extent of similarity that is required to meet the "in accordance with" test.

If the prior practice is defined in very specific terms and "in accordance with" is applied so as to require the **same** practice, it will be very difficult for the relevant distribution to be in accordance with the prior practice. Minor differences as compared to the regular practice may be sufficient to meet the condition in section 207-159(1)(a)(i).

At the least, it is submitted that the test for the relevant distribution should be whether it is **substantially in accordance with** the regular practice.

The condition in section 207-159(1)(a)(ii) will necessarily be met where the dividend payer has no such regular practice. For example, a company which transitions from private / unlisted ownership to the listed market may have no regular practice of paying dividends, and upon paying dividends in a listed environment, it will automatically meet the condition in section 207-159(1)(a)(ii).

Section 207-159(3)

In addition to the uncertainties noted above regarding the established practice, section 207-159(3) is to be taken into account. Consider an example where:

- a listed company has since 2016 declared fully franked dividends and offered a dividend reinvestment plan to shareholders, in lieu of a cash paid dividend;
- this arrangement has occurred on a regular basis and is intended to continue on a regular basis.

Section 207-159(3) requires that in testing whether there is a regular practice in the sense required by section Section 207-159(1), prior period distributions are to be **disregarded** if:

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- the prior period distribution is a franked distribution, or would be a franked distribution if Section 207-159(1) did not apply to the distribution; and
- Section 207-159(1) would apply to the distribution if Section 207-159(1)(a) were omitted. In other words, the conditions in Section 207-159(1)(b) and (c) are met. Arguably, merely by virtue of having offered a dividend reinvestment plan, those conditions will be taken to be satisfied.

It seems to us that whilst such a company has had a (commercially speaking) recurring and ongoing practice, it will not be able to establish a regular practice in the sense required by section 207-159(1)(a)(i) and will therefore necessarily fall into section 207-159(1)(a)(ii).

Further, as noted below, the proposed measures if activated have the effect of causing the whole of the distribution to be unfrankable: this has the effect that in the above example, all dividends since 2016 could be wholly treated as unfrankable.

Principal effect test

Section 207-159(1)(c)(i) has regard to whether "the principal effect of the issue of <u>any</u> of the equity interests was the <u>direct or indirect funding</u> of the relevant distribution or <u>part</u> of the relevant distribution".

We note that section 207-159(4) sets out factors that are to be taken into account in testing the condition in section 201-159(1)(c) and the EM (at paragraph 1.31) states that only the "main or leading effect of the issue" is relevant. However, we read section 201-159(1)(c)(i) to operate in much wider circumstances given the references to <u>any</u> of the equity interests, <u>direct or indirect</u> funding and <u>part</u> of the relevant distribution. Consider an example where:

- a company raised $1000 of funds by way of equity, $999 of which was used to acquire capital assets;
- the company had $499 of available cash reserves;
- at or around the same time, the company declared a fully franked dividend (cash paid) of $500.

In that case it could be said that the principal effect of the issue of <u>any</u> of the equity interests (eg, $1 of the equity raising) directly or indirectly funded a part of the $500 dividend (i.e, $1 of the cash paid dividend can be relevantly traced to the equity raising), with the result that the whole of the $500 dividend would be unfrankable. This example appears to be consistent with the comments in the EM at paragraphs 1.35 and 1.36.

We submit that the principal effect test needs to be narrowed.

More generally, this again highlights the significant impact of the proposed measures in that just $1 of relevant capital raising can cause an entire dividend payment to be treated as unfranked. It is submitted that this is inappropriate and excessive.

Issue of equity interests – any other entity

Section 207-159(1)(b) provides that the provisions cover the issue of equity interests by any other entity. Again, the original announcement and the TA were silent on this issue. Consider an example where:

- company A takes over company B;
- in order to fund the acquisition, company A raises equity;

- in connection with the change in ownership, company B pays a pre-completion dividend to its long-standing shareholders.

In this circumstance, the now former shareholders of company B could be penalised as a result of how company A has funded the takeover transaction.

Due to the measures proposed retrospectivity, application of this “other entity” aspect of the measures should be restricted to arrangements after the date of issue of the ED.

5 Practical matters

Tax administration and certainty: prospective
A consequence of the broad drafting of each of the conditions at paragraphs (a), (b) and (c) is that companies will likely, on a mass scale, apply for private rulings to obtain certainty, including in respect of arrangements which objectively are consistent with the operation of the imputation system. For example, companies may determine that ordinary dividend reinvestment plans need the certainty of such a ruling. This will likely impact the efficient operation of the tax administration.

Tax administration and certainty: retrospective
The tax liability impact of the distribution being unfrankable will be at the shareholder level. If the provision is activated for prior years in the context of widely held companies, this presents a significant practical issue for as to how potentially affected companies, potentially affected shareholders (including those who are no longer shareholders in the relevant company) and the ATO will respond.

In respect of **prior periods** only, a possible way to reduce this uncertainty is to require (via the Transitional Provisions Act) that the provisions will only be operative if the Commissioner makes a determination that the provisions apply.

Relevant to this, it is not clear what is intended by item (2)(b) of the application provision: this provides that the normal section 170 time limits (which may otherwise have expired) will not apply to certain assessments made prior to the commencement of this measure (eg, a franked dividend and associated assessment in the 2018 year) provided that, inter alia, the amendment is made within 12 months of commencement.

This highlights the difficulties associated with the six year retrospective operation of the provision:

- The measures propose to create a law which operates for prior years, many of which are, in the normal course, out of time for amendment;
- In response to this, it is proposed to extend the normal amendment periods;
- However, this extension is only effective if the relevant amendment is made within 12 months of commencement.

Is this mechanism intending to provide that for distributions that have been part of a shareholder assessment prior to commencement, that particular shareholder will only be subject to the consequence of these provisions if the Commissioner takes positive action to issue an amended assessment to that particular shareholder within 12 months of commencement?

It is submitted that greater certainty is required as to what is reasonably expected of a dividend paying company, and shareholders at large during that 12 month post commencement period, given the breadth of the proposed measures, which could potentially apply to hundreds of companies (including widely held companies), in respect of thousands of dividends which have previously been paid to millions of shareholders.

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Yours sincerely

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