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Franked Distributions and Capital Raising – Treasury ED Law

Dear Director

Ernst & Young (EY) welcomes the opportunity to respond to the exposure draft law (ED) and draft explanatory material released by Treasury on 14 September 2022 concerning proposals to prevent the distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities (inserts for *Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings*).

The ED proposes to introduce new law to implement the 2016/17 Mid-Year Economic and Fiscal Outlook (MYEFO) announcement which was intended to address artificial and contrived arrangements identified in 2015, as expressed in the ATO taxpayer alert TA 2015/2 Franked distributions funded by capital raising to release franking credits to shareholders.

However, the proposals as drafted may apply much more broadly than to artificial arrangements, potentially impacting ordinary capital management activities. They introduce complex new restrictions on how companies may pay franked dividends to shareholders and will increase taxpayer costs of compliance and increase uncertainty in Australian capital markets for both Australian and foreign investors.

We outline below two key areas of concern with the proposals as drafted:

- The retrospective application of the proposals, almost 6 years after they were announced (with final law still to be introduced and enacted)
- The breadth of the proposals resulting in significant uncertainty as to their application.

We recommend:

- The proposed law should only apply to distributions made after the date which the law is enacted. If this is not changed then the additional time for the Commissioner to amend assessments should be removed
- A clearer tax avoidance purpose requirement should be added
- That only that proportion of the distribution which was funded by a capital raising is treated as being unfrankable.

We have also contributed to the joint submission by CA ANZ and the Corporate Tax Association, and we support their submission and recommendations to the extent that we have not covered an issue in our submission.

Retrospective application

It is proposed that the law when enacted will apply to distributions by a company made on or after 12 pm, Australian Capital Territory time, on 19 December 2016. A special rule will provide the Commissioner of Taxation with additional time to amend an assessment for the application of the law for distributions made after that time, only limited by a 12 month period after the date the amendments commence for assessments that would otherwise be “out of time”.

The effect of the provision is to make distributions unfrankable. It follows that any taxpayer that had directly or indirectly received a franked dividend that is subject to these provisions will now have an unfranked dividend and would potentially be subject to an amended assessment.

Subject to the final form of the law and any changes made in response to concerns that the provisions are drafted too widely, the impact of the provisions applying may be significant including that the assessments of a significant number of individual taxpayers might be impacted including individuals who otherwise would have a 2 year amendment period. Superannuation funds, managed funds and listed investment companies and their members might also be impacted.

Significant practical issues and additional costs of compliance will arise for impacted companies, their shareholders and other recipients. Complexities will include circumstances where dividends were paid to trusts and non-resident withholding tax adjustments. The ATO will need to consider how they manage this issue in a self-assessment environment and provide guidance at the time the final law is introduced into Parliament.

There will be difficulties for companies to demonstrate that they have not breached the proposals for distributions made before the law is final. Companies cannot have considered the elements of the provision before the ED was released so will not have contemporaneous documentation to support their positions. Rather companies will have to apply the new law to previous dividend payments to the satisfaction of the ATO. We note that this approach has denied proper administrative process to companies in that they were not able to apply for and obtain binding rulings from the ATO for dividends paid before the law is enacted.

We recommend that the proposed law should only apply to distributions made after the date that the law is enacted. If the application date is not changed then at a minimum the proposal to allow the Commissioner additional time to amend out of time assessments should be removed.

Proposals are too broad

The breadth of the proposed law seems to go beyond what was expected to combat arrangements identified in 2015 as expressed in the ATO taxpayer alert TA 2015/2 and the 2016/17 MYEFO announcement which was stated to be to address those ATO issues.

The ED law is not clear on what the “integrity issue” is with utilising otherwise bona-fide franking credits. The law does not describe the mischief which is sought to be addressed, which will cause issues for interpreting the law.

The first and third requirements in proposed subsection 207-159(1) could be applied very widely and capture many arrangements that were not done for the purpose of tax avoidance or to manipulate the franking system and which are not artificial.

The proposed "established practice" element is loosely drafted including it is unclear what period is to be considered. The law needs to also recognise that whilst dividend practices may remain broader consistent over the longer term, practices can vary in the shorter term and the level of franking may change quite materially. E.g., covid impacts/financial crisis may impact short term payment or result in cessation of dividends. Also, the dividend practices of listed companies will be different to private companies in considering what is a regular dividend payment practice.

In particular the proposals would allow the ATO to connect otherwise remote capital raising events with dividend distributions when applying the provisions.

The TA was concerned when the distributions happened "At a similar time to the capital raising… in a similar amount to the amount of capital raised". It should not be open for the ATO for example to suggest an equity raise in 2021 causes an issue with a special dividend paid in 2022.

The "principal effect" of the equity interests requirement lacks a clear connection to an avoidance or manipulation purpose. While the "purpose test" might have some connection to the general anti-avoidance rules, the overall conclusion to be determined might be interpretated as requiring the determination of a question of fact looking at a tracing of the use of funds.

We recommend that a clearer tax avoidance purpose requirement should be added to the proposals.

Application to whole of distribution

Where the provisions apply to only part of a distribution then the whole of that distribution will be unfrankable. For example, if a dividend was funded 50% by the issue of equity interests and the requirements of the provision are met in respect of the part of the distribution which it has funded, then 100% of the distribution is subject to the proposed section and is unfrankable notwithstanding that 50% of the distribution was funded by retained cash or a borrowing.

This result seems unduly harsh in particular where the provisions are applied retrospectively.

We recommend that where distributions are subject to the proposed integrity measure that only that proportion of the distribution which was funded by a capital raising is treated as being unfrankable.

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Yours sincerely

Ernst & Young