27th September 2022

Director
Corporate Tax Policy Unit
Treasury
Langton Cres
Parkes ACT 2600

By email: frankeddistconsult@treasury.gov.au

Dear Sir/Madam,

Submission on Franked Distributions & Capital Raising

We are pleased to provide a response to the Consultation on the proposed legislation relating to Franked Distributions & Capital Raising.

A. Proposed legislation has many unintended consequences for normal business operations

We recognise and appreciate the intent of the legislation – which is to prevent situations of intended tax avoidance and manipulation of the franking system.

However we seek to highlight that the proposed legislation as drafted would appear to inadvertently catch many thousands of situations of legitimate company operation and could accordingly delay or significantly discourage the normal processes of capital raising, investment and economic growth within Australia.

That is, the legislation does not sufficiently distinguish between acceptable activities and the mischief it properly seeks to address.

B. Matching of cash flows between capital raisings and distributions can frequently represent the normal and sensible processes of commercial capital management

It is a normal incident in the running of either operating businesses or investment businesses to generate a profit and invest the resulting cash flows productively (by purchasing a further asset or applying the funds into the ongoing operations). Companies are expected to productively utilise their capital at all times and not merely hold cash until such time as it is distributed to shareholders.

In some cases the reinvestment of profits may even be outside the control of the company (for example, a dividend paid by an in-specie distribution of an asset in lieu of cash, or a demerger that includes a deemed dividend component).

Once a company has generated a profit and reinvested it – it can only create liquidity to pay a subsequent dividend in one of a few ways:

(a) Raise debt – which for many may be neither viable, sensible nor desirable

(b) Sell some of its investments or other assets – which incurs transaction costs or may simply not be viable if the investment is illiquid; or

(c) Raise capital.

The raising of capital at (c):

- Accepts cash inflows from those investors wishing to increase their ongoing investment in the company;
- Implicitly applies the capital raised to the ongoing funding of the investments it has recently purchased (in substitution for the funding previously provided out of profits);
- Thus frees the cash from its previously earned profits and applies that cash to the payment of a dividend from those profits;
- While preventing the company from the unnecessary, costly and undesirable actions of having to sell the assets it just purchased.

This process has nothing whatsoever to do with tax avoidance and the manipulation of the franking system. It is merely a normal exercise in cash flow management.

The company has legitimately earned profits that it should be entitled to distribute.

Yet under the proposed legislation these actions would potentially fall foul of two of the key criteria, leaving the company unable to pay a franked dividend from its profits.

A core element of the proposed legislation is to disallow the franking of dividends if a capital raising has the **principal effect or purpose** of funding a dividend - and if they also fail the established practice test. (As we note below, many normal situations of company operation will also fail the established practice test.)

In the example given above the raising of capital is highly likely to be considered to have the purpose and effect of indirectly funding the distribution, and accordingly the franking of dividends would be disallowed under the proposed legislation where the dividend also failed the established practice test.

The example we have provided suggests that the raising of capital to fund a dividend from previously earned profits – is not in itself a cause of tax evasion. The proposed legislation appears to be incorrectly targeting a normal and acceptable action – rather than targeting the very specific circumstances related to the tax evasion it seeks to prevent.

C. Problems with the Established Practice Test

The legislation seeks to overcome the fact that the "effect" and "purpose" tests inadvertently catch many legitimate situations by exempting dividends that are part of the normal "established practice" of the company (so long as the established practice isn't to fund dividends out of capital raisings).

A company that pays regular dividends and raises capital occasionally could hope that this constitutes "established practice" and they would be allowed to pay franked dividends.

However, we wish to highlight that there are still many legitimate situations that will not satisfy the "established practice" requirement. A possible (but not exhaustive) list of situations would include:

(a) A company that both routinely reinvests its profits and raises capital. While this represents nothing more than common sense cash flow management and with no intent to manipulate the tax system, this would appear to fall foul of Clause 1.23 in the Explanatory memo which suggests that a past practice of funding distributions from capital raisings isn't acceptable.

(b) A newly established company that has no "established practice";

(c) Companies paying special dividends due to abnormal profits;

(d) Companies changing their dividend payout policy or changing the timing of dividends;

(e) High growth companies that have high reinvestment needs and which may only pay dividends irregularly;

(f) Companies operating in volatile industries where dividends are only paid irregularly;

(g) Companies with a small number of assets or investments whose income is generated irregularly and who only pay dividends irregularly;

(h) Companies receiving a large in specie distribution in lieu of cash where their resulting income is materially higher than normal (eg from a demerger)

(i) Companies investing in businesses that go through large capital restructures and which generate irregular profits.

The list of legitimate situations that would not constitute "established practice" is large.

On this basis, we highlight that an "established practice" test does not act as a sufficient filter to distinguish between tax avoidance and the legitimate and normal operations of many businesses.

D. Retrospectivity

The issue of whether a retrospective application of laws is appropriate is a secondary issue which depends on the nature and merit of the core legislation.

Accordingly, with the core legislation appearing to inadvertently target many legitimate situations, it may not be appropriate to form a conclusive judgment as to retrospectivity.

However we note the following:

- If the core legislation accurately targeted actions that were knowingly designed to achieve tax avoidance in the past, a case could be made for retrospectivity.
- If the legislation targeted a matter of subjectivity, policy, planning or business operation then it would be inappropriate to apply the law retrospectively.

E. Conclusion

We appreciate that there may be mischievous situations involving tax avoidance and dividend distributions that Treasury understandably seeks to deal with through an appropriate piece of tax avoidance legislation.

However the "established practice" and "effect" and "purpose" tests, rather than limiting the legislation to a few instances of mischief, would appear to inadvertently catch tens of thousands of normal and legitimate situations.

Accordingly we question whether they are a suitable construct with which to design this legislation.

The problem lies at the conceptual heart of this proposed legislation:

- **The funding of distributions out of capital is a matter solely of cash flow management. It is not tax avoidance in its own right and should not de-legitimise dividends so funded.**
- **The payment of dividends where no profit has been earned is a separate matter entirely and the one that the legislation should seek to address.**

We would be happy to discuss any aspect of the matter should this assist.

Yours faithfully,

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Listed Investment Companies & Trusts Association Ltd