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Law Council
OF AUSTRALIA
Business Law Section

Director
Corporate Tax Policy Unit
Treasury
Langton Crescent
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By email: frankeddistconsult@treasury.gov.au

Dear Director

Franked distributions and capital raisings

1. This submission relates to the exposure draft legislation *Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings* (**Exposure Draft**), together with the accompanying Explanatory Statement documents, which was released by Treasury for public comment on 14 September 2022.

2. This submission is made by the Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**).

Key Points

3. The key matters the Committee wishes to raise in respect of the Exposure Draft are set out below. It considers that:

   (a) The retrospective application of the measure is not appropriate.

   (b) The Exposure Draft contemplates a potential expansion of the Australian Taxation Office's (**ATO**'s) ability to issue amended assessments which is unnecessary.

   (c) The proposed measure introduces a commercial bias which should not be imposed by the tax system—namely:

      (i) to limit the payment of dividends outside of a periodic dividend cycle; and

      (ii) to create a bias towards the retention of cash to pay dividends in future by focussing on the source of cash resources funding dividends, as opposed to whether there are available profits.

(d) Existing legislation, primarily section 177EA, can properly deal with the perceived mischief ostensibly to be dealt with by the measure.

(e) The wide scope of the threshold for the operation of the measure is not appropriate. It will apply in a wide range of circumstances which are outside the perceived mischief to which the measure is directed.

(f) There can be disproportionate effects from the application of the measure, which causes the entire distribution to be unfrankable even where the equity interests issued fund only part of the distribution.

(g) The combination of the above concerns means that, if the Exposure Draft is to be enacted, both the scope and impact of the operation of the measure must be refined.

Submissions

Retrospective application of the measure

4. Consistent with the rule of law,[1] and as a matter of general policy, tax measures should only apply prospectively.

5. In Treasury's 2004 *Report on Aspects of Income Tax Self Assessment* (**AITSA Report**),[2] it was observed that "ideally, tax measures imposing new obligations should apply prospectively". No doubt, the reason for this is, as the plurality (Keane, Gordon, Edelman and Gleeson JJ) recently observed in *Stephens v R* [2022] HCA 31 in a non-tax context, that "retrospective laws … are capable of defeating reasonable expectations concerning existing rights": at [29].

6. The Committee acknowledges that Treasury recognised in the AITSA Report that there will be circumstances where it is appropriate as a matter of good tax policy for the government to make an announcement and then enact retrospective legislation with effect from the date of that announcement. The AITSA Report identifies three circumstances where a retrospective start date may be appropriate, being where the measure:[3]

   (a) corrects an 'unintended consequence' of a provision and the ATO or taxpayers have applied the law as intended;

   (b) addresses a tax avoidance issue; or

[1] Justice Michelle Gordon, 'The Commonwealth's Taxing Power and its Limit – Are we there yet?' (2013) 36 *Melbourne University Law Review* 1037 at 1061, citing Chief Justice Murray Gleeson, 'Courts and the Rule of Law' (Speech delivered at the Rule of Law Series, the University of Melbourne, 7 November 2001).
[2] Treasury, *Report on Aspects of Income Tax Self Assessment* (August 2004).
[3] Treasury, *Reports on Aspects of Income Tax Self Assessment* (August 2004) pg 70; see also Australian Law Reform Commission, *Traditional Rights and Freedoms – Encroachments by Commonwealth Laws (ALRC Report 129)* (December 2015) [13.94]-[13.95],[13.117]-[13.120].

(c) might otherwise lead to a significant behavioural change that would create undesirable consequences, for example, bringing forward or delaying the acquisition or disposal of assets.

7. The measure in the Exposure Draft is described as an "integrity measure" which, on its proposed terms, applies regardless of whether there is a purpose of tax avoidance. It is directed to denying a tax offset regardless of the characteristics of the entity entitled to the distribution. It follows that, while it is described in the draft Explanatory Materials as an "integrity measure", it is not directed to a "tax avoidance issue". Consequently, this is not a circumstance in which the measures should be given retrospective operation.

8. More importantly, the justification for retrospectivity appears to be the announcement in the *2016–17 Mid-Year Economic and Fiscal Outlook* (**Announcement**).[4] The Announcement stated:

> "*The Government will prevent the distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities. This measure will address the issues raised by the ATO in Taxpayer Alert TA 2015/2: Franked distributions funded by raising capital to release credits to shareholders.*"

9. TA 2015/2 was concerned with arrangements that displayed all or most of the following features:

   (a) A company with a significant franking credit balance raises new capital from existing or new shareholders. This may occur through issuing renounceable rights to shareholders. Shareholders may include large institutional superannuation funds.

   (b) At a similar time to the capital raising, 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.

   (c) Overall:

      (i) there is minimal net cash inflow to or outflow from the company;

      (ii) the net asset position of the company remains essentially unchanged (in a buy-back variant, the number of shares on issue following the transaction may be marginally reduced due to the difference between the buy-back price and the issue price of the new shares) but their franking account is significantly reduced; and

      (iii) there is minimal impact on the shareholders, except in some cases they may receive refunds of franking credits, and in the

[4] Explanatory Materials, pg 11 [1.55].

case of buy-backs, they may also get improved capital gains tax outcomes.

(A) The franked distributions (or franked component of the buy-back consideration) may be unusually large compared to ordinary dividends previously declared and paid by the company (as distinct from a typical dividend reinvestment plan applicable to an ordinary regular dividend).

(B) The franked distribution may be receivable by all existing shareholders of the company.

10. The proposed measure is not conditional upon:

    (a) the distribution-paying entity’s shareholders including large institutional superannuation funds;

    (b) the making of franked distributions “in a similar amount” to that raised in a near contemporaneous capital raising;

    (c) there being “minimal net cash inflow … or outflow”;

    (d) the net asset position of the company remaining essentially unchanged; or

    (e) the franked distributions being unusually large.

11. In short, the Draft Bill is not “in line with” the Announcement. Corporate entities and shareholders who acted in reliance upon that announcement and determined that the proposed measure would not apply to them because of the significant differences between their arrangement and that identified in TA 2015/2 will be unfairly adversely impacted.

12. It is not appropriate to enact retrospective legislation that denies benefits to shareholders on the premise that it is “in line with” or “gives effect to” a prior announced legislative change and then enact legislation that denies the benefit to shareholders in a much broader range of circumstances contemplated by the announcement. The relevant legislation must appropriately reflect the form and nature of the announcement. In this case, it does not.

13. It is also relevant to observe that it is important in the event that there is a tax change by press release that there is prompt enactment of the relevant legislation. The Draft Bill has been released around five years after the Announcement. In the context where there remains a significant list of unenacted announcements, this creates particular difficulties for tax compliance.

Expansion of ATO compliance activity

14. The Draft Bill not only contemplates retrospective application, but would also implicitly expand the power of the ATO to issue amended assessments.

15. The nature of the regime is such that it is likely to impact a broad range of shareholders in the relevant company which undertook the capital raising and

made a relevant distribution.

16. As noted above, the expanded ability of the ATO to issue amended assessments is compounded by the fact that the Draft Bill has retrospective application, and may apply to arrangements not originally contemplated by TA 2015/2 or the Announcement.

17. Importantly, the ATO commented in its 2021 Reportable Tax Positions Schedule Findings Report that its:

> "*risk identification processes and assurance programs have confirmed [that arrangements flagged as being reviewed pursuant to Taxpayer Alert 2015/2 (TA 2015/2)] are no longer prevalent in the large public and multinational business population*".

18. When the measure was first introduced in the 2016 announcement, it was only estimated to have a revenue gain of $10 million per year.

19. In these circumstances, it is not appropriate for retrospective legislation to be introduced, despite it being purportedly based on a press release in 2016.

<u>Inappropriate commercial outcomes</u>

20. The measure would result in different rules being applied to companies that pay periodic dividends and those that do not pay periodic dividends.

21. In effect, the measure introduces a commercial bias to not pay dividends outside a periodic dividend policy, given any distributions distinct from an established practice by the company could be scrutinised under the measure.

22. This is an inappropriate commercial limitation.

23. At its core, the measure does not allow the company the flexibility of using cash generated profits for reinvestment without the risk that a subsequent capital raising would not allow a distribution of profits which has been fully taxed.

24. The tax mischief, which is the focus of the measure, appears to be a mismatch between the level of franking credits available to pay a dividend and the cash resources of a company. The manner in which a company manages cash resources generated through profits that have been the subject of franking credits should not make a difference on the ability to pass franking credits to a shareholder.

25. The Committee considers it would be an odd outcome for the company raising capital to pay its working capital expenses that the monies retained over time by the company could be used to pay a special dividend whereas, if the monies raised through the periodic profits are used to pay the excess working capital expenses, a subsequent capital raising cannot be used to pay a dividend.

26. The availability of franking credits on the payment of dividends proportionately to all shareholders should be simply restricted to the availability of profits. The Committee considers that it should not be dependent upon the source of the cash from which the dividend is paid.

Existing legislation can properly deal with the perceived mischief

27. In the context of the current structure dealing with the prevention of inappropriate allocation of franking credits on dividends paid to shareholders, the Committee suggests that the provisions of section 177EA should be regarded as adequate to deal with the requisite concern.

28. The existing provisions dealing with arrangements of this type, and the existing provisions dealing with off-market share buy-backs, should adequately deal with the mischief raised in TA 2015/2.

Commercial impact of the current drafting

29. The Committee is concerned with the current broad drafting of proposed section 207-159.

30. The Committee is concerned with both:

    (a) the wide scope of the threshold for operation of the measure; and

    (b) the disproportionate effect of the measure when it is applied, which causes the entire distribution to be unfrankable even where the equity interests issued may only fund part of the distribution.

31. The Draft Bill, as currently drafted, would affect many public companies materially and adversely. The Committee refers to the effects outlined in the submission on the Draft Bill made on behalf of the Corporate Taxpayers' Association (**CTA**), which provide the Committee with a copy. It agrees with the observations made by the CTA in relation to the impact of the proposed measure. In addition, it would have a unique adverse impact on banks, which should be remedied.

32. The position of banks should be properly dealt with, given their systemic importance to the stability and prosperity of Australia's financial system, and to the income and retirement savings of a large proportion of the Australian population.

33. This could be achieved through a specific exclusion for banks, or for issues of equity interests undertaken for a purpose reducing the likelihood of non-compliance with prudential regulatory standards. Alternatively, proposed subsection 207-159(3) could be omitted from the Draft Bill.

34. In the ordinary course of business capital management activities, banks often issue capital instruments at times, and in amounts, which coincide with their distribution of regular dividends.

35. Banks are subject to APRA's capital adequacy requirements and issue regulatory capital for purposes entirely apart from a desire to pass on franking credits to shareholders, despite any such coincidence. Australia's banks are well capitalised and have ample cash reserves to fund distributions to shareholders, but the fungibility of funds raised means that a principal effect of bank capital raisings may very well be to fund, directly or indirectly, all or part of a dividend paid by a bank, attracting the operation of the proposed legislation.

36. Unless a bank can satisfy the purpose or principal effect test for each dividend it pays, proposed subsection 207-159(3) will apply to disregard those dividends for the purpose of determining whether a bank has a regular pattern of paying

dividends under proposed section 207-159(1)(a).

37. Given the regular capital management activities undertaken by banks, the effect of proposed section 207-159(3) is to negate the concession for dividends paid according to a regular pattern in section 207-159(1)(a).

38. The proposed legislation as currently drafted will also put at risk the use of dividend reinvestment plans (**DRPs**) by all companies including banks. Many DRPs are structured as an issue of new shares (sometimes also with a discount). Participants can then apply all or part of the funds from dividends received towards the issue of those new shares.

39. The proposed legislation could apply to those DRPs because, although strictly speaking the dividend funds the issue of shares (rather than the issue of shares funding the dividend), the measure applies to the issue of equity interests “before, at or after the time” at which the distribution was made.

40. This issue is even worse for DRPs that are underwritten—that is, where an underwriter agrees to subscribe for new bank shares equal to the shortfall of a desired capital raise amount and the natural take-up by DRP participants—as underwriting is expressly specified as a consideration relevant to determining whether the purpose or principal effect tests are satisfied and was called out in the Announcement.

41. An application of the proposed legislation to DRPs (and underwritten DRPs) is fundamentally misguided. DRPs are offered to shareholders for genuine commercial reasons including to give shareholders an opportunity to increase their shareholding conveniently and without brokerage or other transaction costs and to maintain strong shareholder relations in a competitive capital market.

42. There are good commercial reasons for underwriting a DRP, when compared with a full institutional or retail placement. It is a convenient and cost effective means of raising small amounts of capital to fine tune capital adequacy ratios.

Low threshold for the application of the measure

43. The Committee is concerned with the scope of the measure.

44. The application of the measure should be tested in respect of the capital raising as a whole and the distribution as a whole.

45. Currently, the threshold examines whether all or part of a capital raising has a requisite connection with all or part of a distribution.

46. Testing the measure in respect of part of the relevant distribution and part of a capital raising will lead to inappropriate and potentially unintended operation of the measure.

47. In addition, the threshold considers the principal effect of the issue on equity interests and the purpose of the issue of equity interests as alternatives.
    If enacted, the Committee considers that both requirements should be required to be satisfied.

48. The application of the purpose test in isolation would effectively make the principal effect of the principal effect test redundant.

49. The Committee is concerned that the current drafting may apply to more circumstances than was expressed in TA 2015/2 and the Announcement. In particular, the broad drafting of the proposed legislation provides further uncertainty as to what transactions may be within the scope of the measure.

<u>Disproportionate impact from the application of the measure</u>

50. The Committee is also concerned that the broad impact of the application of the measure is disproportionate to the perceived mischief to be addressed by the measure.

51. If the threshold for the application of the measure is passed, then it should only be applied to the relevant portion of the distributions that is funded through the capital raising. If part of a relevant capital raising is used to fund part of a distribution, it should result in the whole of the distribution being impacted.

52. Under proposed section 202-45(ea) of the *Income Tax Assessment Act 1997* (Cth), an entire distribution will be unfrankable where the distribution satisfies the test in proposed section 207-159.

53. This would mean that the entire distribution ceases to be able to be franked even if the test is satisfied in relation to:

    (a) some of the capital raised from an issue of equity interests; or

    (b) part of a franked distribution.

54. It appears that it is sufficient for the measure to apply where the purpose of an equity raising was only to fund a part of the distribution directly or indirectly. It is unclear why the whole distribution should cease to be frankable, when the capital raising activity only funds a part of the distribution. If the measure is to be legislated, it should be capable of applying to only the part of the distribution that is funded by the capital raising.

55. Given the nature of the impact of these provisions, the measure, if it is to be enacted, should provide for its application to be assessed by reference to:

    (a) the issue of equity interests as a whole; and

    (b) the relevant distribution as a whole.

56. When applied, it should only impact the relevant part of the distribution that is funded by the capital raising, not all of the distribution.

Further contact

57. The Committee would be pleased to discuss any aspect of this submission.

Yours faithfully

Philip Argy
Chairman
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