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11 October 2022

Director
Corporate Tax Policy Unit
Treasury
Langton Cres
PARKES ACT 2600

By Email: *frankeddistconsult@treasury.gov.au*

Dear Sir/Madam

FRANKED DISTRIBUTIONS AND CAPITAL RAISING

1. Thank you for the opportunity to provide comments to the Exposure Draft legislation *Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings* ("**ED**") and accompanying draft explanatory materials ("**EM**").

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many clients that would be impacted by the measures proposed in the ED.

3. We do not support the introduction of the proposed measures contained in the ED. In our view:

   3.1. There is no policy reason why this provision should be applied to privately owned groups.

      3.1.1. Dividends are generally paid through to corporates or individuals (via a trust) who marginal tax rate exceeds the corporate tax rate (i.e. 32.5% marginal tax rate starts from $45,000 of taxable income). It is not common for private companies to be owned by superannuation funds.

      3.1.2. New equity participants may require pre-acquisition profits to be distributed before acquiring new shares in the company (as the pre-acquisition profits 'belong' to the pre-existing shareholders). Taking into account 3.1.1 above, there is no mischief or integrity concern for such arrangements which are commercially driven and seek to clean-up the company's balance sheet prior to a new owner investing in the company.

[redacted]

3.1.3. Private groups commonly use at call loans (which are often classified as non-share equity) to fund operational cash flows. Furthermore, the payment of a dividend may be credited to an 'at call' loan account to pay for future personal expenses (when managing Division 7A). Denying franking credits in this circumstance would make it harder for shareholder in private companies to comply with Division 7A.

3.1.4. If a shareholder that is a non-fixed trust were to distribute the dividend to a superannuation fund, this would breach the non-arm's length rules with the dividend taxed at 45%.

3.1.5. Accordingly, the ED should not apply to private groups in the current format. We strongly recommend that Treasury consults appropriately with industry to understand these significant concerns and the inadvertent and unnecessary impact that this provision will have on private companies.

3.2. Based on information published by the ATO, there appears to be no basis for applying this provision retrospectively as there is no indication that the revenue is at risk for prior income years. The ATO have indicated that arrangements of concern "are no longer prevalent in the large public and multinational business population".[1] Furthermore, based on our comments above, we do not believe that there is a revenue risk with respect to private groups. We therefore strongly oppose this aspect of the ED.

3.3. In addition to the above, the integrity concern is not stipulated in any document released by Treasury or the Australian Taxation Office ("**ATO**").

3.3.1. Presumably, Treasury is not concerned with companies raising capital to fund the distribution of franked dividends to top marginal rate taxpayers who would be required to pay an additional $17 of tax on every $70 of franked dividends, or non-residents who would not receive any imputation benefits. Applying the proposed measure in relation to such shareholders would simply result in double taxation.[2]

3.3.2. We understand that the main concerns involve franking credits being streamed to entities such as complying superannuation funds whose tax rates are less than the corporate tax rate such that they would be able to receive a refunds of excess franking credits (or use them to shelter other taxable income).

3.3.3. However, the proposed rules will apply where there is no streaming of franked distributions to certain classes of shareholders and may apply where all shareholders receive their share of the franked dividend in question. It is critical that the Government and Treasury outline their integrity concern in the EM.

3.3.4. If the Government is concerned about the 'early release of franking credits (funded by equity) where shareholders are industry superannuation funds, then this should be stated as the reason for the amendments or the provisions. Accordingly, Treasury can

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1 2021 Reportable Tax Positions Schedule Findings Report.

2 An effective rate of 62.9% for individuals on the top marginal tax rate on underlying corporate profits [100% - (53% x 70%)] or 40.5% for non-residents [100% - (85% x 70%)], assuming access to a 15% dividend withholding rate under a tax treaty).

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highlight that they are concerned about the risk to revenue in cases where dividends would not otherwise be paid.

3.4. By stipulating the reason for the amendments, we believe that Treasury should be in a position to form the view that this integrity concern should not arise for private companies.

3.5. Finally, we believe that section 177EA (as outlined in TA 2015/2) and Subdivision 204-D already exist as two integrity provisions that are supposed to deal with this situation. From a complexity and compliance perspective, we would strongly recommend that Treasury consider amendments to these provisions to cater for the perceived integrity risk, rather than introducing a new and potentially overlapping measure.

4. We have provided further detail below in relation to the points that we have raised above. We would strongly recommend that Treasury liaise with industry to ensure that these points are properly understood.

Exclusions for private companies

5. We strongly recommend that the measure proposed in the ED be limited to public companies[3].

5.1. The announcement in the 2016-17 Mid-Year Economic and Fiscal Outlook stated that a measure will be introduced to address the issues raised in TA 2015/2.

5.2. TA 2015/2 states that the Australian Taxation Office ("**ATO**") is reviewing arrangements involving capital raising which may occur "through issuing renounceable rights to shareholders" which may include "large institutional superannuation funds".

5.3. The features outlined in TA 2015/2 alert make it clear that the integrity risk relates to public companies, as private groups, as a general rule, do not raise capital through renounceable rights and do not have large institutional superannuation funds as shareholders.

5.4. We understand that the risk to revenue from capital raising activities being used to fund franked distributions is where these distribution flow to complying super funds. We understand that the Government is concerned about the early release of franking credits where they cannot otherwise be funded public companies (using existing cash or debt).

5.5. The non-arm's length income rules and in-house asset rules contained in the superannuation provisions generally prevent private company dividends flowing to self-managed superannuation funds. In most cases, franked dividends paid by private groups are taxed at the corporate rate or higher personal marginal tax rates such that the same risk to revenue does not exist in this population of taxpayers.

5.6. Additionally, the ED refers to underwriting arrangements as being a relevant factor. Again, such arrangements do not typically arise for private companies.

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[3] Section 103A of the *Income Tax Assessment Act 1936* ("**ITAA36**").

6. From a compliance perspective it will be very difficult for private companies to comply with the proposed new provisions.

   6.1. Private companies that are closely held do not generally have a practice of making franking distributions on a regular basis. Proposed section 207-159(1)(a) of the *Income Tax Assessment Act 1997* ("**ITAA97**") would therefore almost always be satisfied for every franked distribution made by a private company.

   6.2. Private companies are often funded through at call loans from related parties that are made on an ad-hoc basis. Such loans would generally be treated as an equity interest in a company under the debt-equity rules.[4] Where such loans are interest-free, these arrangements are no different in substance to the company using debt to pay a dividend to its shareholders.

   6.3. A private company may pay a (franked) dividend to a shareholder in order to fund future private expenses of the individual. The amount would often be credited to an at call loan which may be treated as a non-equity share interest in the company. This is generally considered (by the ATO) as being part of good Division 7A management (as the company would not loan amounts to shareholders at all where it instead pays dividends to fund future personal expenses). As the proposed section 207-159(1)(b) does not care about whether the 'at call' loan is created before or after the dividend, the new provision may result in the company being taken to pay an unfranked dividend. This would be a disastrous result for taxpayers seeking to comply with Division 7A (i.e. a dividend is paid to ensure that Division 7A does not otherwise trigger an unfranked dividend, yet section 207-59 could then treat such a dividend as being unfranked simply for trying to comply with Division 7A).

   6.4. Applying the provision retrospectively would mean that franked dividends could be treated as unfranked dividends for those prior periods. Given that franked dividends may have been legitimately distributed in accordance with the rules contained in section 207-58 (relating to specific entitlements to franked distributions), the new provision could result in those distributions being treated as unfranked and for such distributions to be ineffective (i.e. as the minutes would generally refer to the application of franked distributions). From a private group perspective, this is likely to create a significant amount of uncertainty with respect to dividends that have otherwise complied with section 207-58 but for the proposed amendment.

   6.5. This is particularly so given that TA 2015/2 was drafted by the Public Groups and International business line in the ATO and refers to features that are not relevant to private groups (e.g. renounceable rights, large institutional superannuation funds as shareholders). Taxpayers in this market have not been put on notice in the same way as large public companies. Retrospective application is therefore not justifiable to private companies.

7. Accordingly, we believe that the proposed measure is very likely to result in smaller taxpayers in the middle market inadvertently triggering the application of proposed section 207-159 in relation to franked distributions made in proximity to an at call loan being advanced to a private company, due to the technical classification of genuine loans as equity interests. We note that the ED and TA 2015/2 is not generally

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[4] We note that subsection 974-75(6) of the ITAA97 contains a limited exception that does not apply to companies with GST turnover of $20 million or more. Companies with turnovers in this range are generally considered "medium business entities" under a range of tax measures.

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concerned with companies borrowing money to fund the payment of franked distributions.

8. Limiting the measure to public companies only will, in our view, strike a more appropriate balance given:

   8.1. the disproportionate compliance costs imposed on smaller taxpayers by the measure proposed in the ED;

   8.2. private companies being likely to always satisfy proposed section 207-159(1)(a) given that they do not have a regular dividend cycle;

   8.3. private companies often raising finance through at call loans that may technically be considered equity interests, but are not the kinds of capital raising activities that TA 2015/2 is concerned with; and

   8.4. the limited risk to revenue for private companies which generally have a much smaller proportion of ownership held by complying superannuation funds as compared to public companies (and which cannot distribute to superannuation funds due to the specific in-house asset, non-arm's length income rules already contained in those provisions).

9. We note that other than Division 7A, the distinction between public companies and private companies for tax purposes mainly arises in the imputation system rules in Part 3-6 of the ITAA97[5] in recognition of the different circumstances that affect public and private companies. As such, there is substantial precedent for this kind of differentiation and one that is already made in the context of applying the franking provisions.

Policy of the provisions

10. TA 2015/2 indicates that the ATO are concerned about the streaming of franked distributions. However, it is clear that the ED does not deal with this concern and instead deals with a situation where legitimately taxed profits are released via equity funding. Accordingly, we believe that this situation does not involve a streaming issue, but instead raises a concern of 'revenue cost' where franking credits are released earlier than what would have occurred if they were funded by cash reserves or by way of a loan. In particular the risk to revenue occurs where those profits are released to shareholders for whom the franking credit is greater than their tax liability on the grossed-up franked dividend. Taxpayers who would not get such benefits from franking credits would generally prefer to defer any 'top-up tax' liability if the profits are otherwise genuinely reinvested by the company to fund its operations. Such taxpayers would be worse off if the company refreshed its balance sheet by repatriating taxed profits and replacing them with share capital.

11. Accordingly, it appears that Treasury and Government are concerned with the revenue cost associated with refundable credits to complying superannuation funds in such a situation where franking credits are released earlier than what would otherwise occur.

12. However, this policy concern is not stipulated in the EM and accordingly it is not clear that this is the concern of Government and Treasury. So that the provisions can be

[5] For example, section 203-20 (benchmark rule), sections 203-40 and 203-45 (franking periods), section 202-75(3) (distribution statements), section 205-70(5) (tax offset arising from franking deficit tax).

drafted consistent with policy, we highly recommend that Treasury are clear (within the EM) as to why the provisions are being introduced.

13. Based on the above, and as noted earlier in this submission, we do not see these concerns arising in the context of private groups. Accordingly, we believe that setting out the policy context will enable Treasury to justify why private companies should otherwise be excluded from these proposed provisions.

Effect on retail investors

14. We note that where the ATO applies section 207-159 this could adversely affect small retail investors who did not engage in any of the relevant mischief.

15. The company itself may not otherwise be affected and may, in fact, be better placed (at the expense of their current and former shareholders) as the treatment of the distribution as unfrankable would result in the company's franking account being increased as the debit to the franking account would have never arisen.[6] This is unlike section 177EA which would result in a debit to the franking account.

16. There may be various other flow-on consequences for other kinds of investors. Where the distributions flow to corporate tax entities, they rely on their distribution statements to credit their franking account. Causing the distribution to be unfrankable means their franking accounts would have been inadvertently overstated such that they may have inadvertently triggered franking deficit tax. Where distributions are made to trusts, there could be extremely complicated adjustments required to give effect to the distributions being make unfrankable. This is because the amendments may make distributions (that are purportedly made in accordance with section 207-58) as being ineffective. Unwinding these distributions would be very difficult and costly.

17. In addition to the additional tax burden, such entities may incur disproportionate compliance costs to adjust all necessary tax returns affected in comparison to a large superannuation fund which may only need to adjust one tax return to remove the gross-up and tax offset associated with the distribution.

18. This is the case both for prospective and retrospective arrangements as it is likely that in most cases the ATO would only apply proposed section 207-159 after conducting a review or audit, by which time the relevant distribution statements would have been issued to shareholders indicating that the distribution was franked.

19. To avoid these outcomes, we highly recommend that (instead) section 177EA or section 204-30(3) be used for such arrangement (with appropriate modifications if these provisions are not currently viewed as adequate to address the perceived integrity risk). This would provide the flexibility to allow the Commissioner of Taxation to either make a debit to the relevant company's franking account and/or treat the part of the distribution as unfrankable. This is the current manner in which subsections 177EA(5) of the ITAA36 and 204-30(3) of the ITAA97 are drafted to deal with situations where the imputation system is manipulated.

20. This would, for example, allow the Commissioner to collect additional tax from large institutional investors without affecting small retail investors directly, by instead allowing the Commissioner to debit the company's franking account to the extent it does not seek to collect from smaller shareholders.

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6 Section 202-5 of the ITAA97 only allows a frankable distribution to be franked.

"Practical effect" test

21. Should the Government proceed with this measure, we submit that the "practical effect" test proposed in section 207-159(1)(c)(i) be excluded from the final version of the legislation for the following reasons.

22. We believe that a "reasonable to conclude" and "non-incidental purpose" test is sufficient without introducing a new type of test into an integrity measure that is not well understood and has not being previously considered in ATO rulings or by the Courts.

23. We note that paragraph 1.34 of the EM states that this test looks at "outcome" rather than "intention". In particular, we are concerned that an integrity rule, that requires some kind of connection between two events, can apply to entities who enter into arrangements with no purpose whatsoever (or merely an incidental purpose) of achieving the outcome that is considered the relevant mischief. We refer to our comments above in relation to private companies which may issue equity interest through at call loans and inadvertently trigger the application of the rule.

24. As money is fungible, there is a risk that it may always be considered that the "practical effect" of the issue of equity interests results in the direct or indirect funding of a franked distribution. Even if the company can trace the funds raised into a specific use (e.g. purchase of a new asset) such that no relevant purpose of funding franked distributions exists, it could nevertheless be concluded that the practical effect of the issue of equity was to indirectly fund a distribution as it freed up funds that otherwise would have been used for the specified purpose.

25. Alternatively, instead of creating an overly complex test, Treasury could simplify the test by phrasing it such that the franked distribution be "reasonably attributable" to the issue of the equity interests. This wording is adopted in section 110-55(7)(b) in relation to pre-acquisition dividends and considered by a unanimous judgment of the High Court in *FCT v Sun Alliance Investment Pty Ltd (in liq)* [2005] HCA 70 as requiring a contributory causal connection[7] between the two subject matters. Such existing judicial principles could inform the interpretation of an integrity rule in place of creating a new kind of statutory test for which no such guidance currently exists.

Section 177EA and Subdivision 204-D

26. As noted earlier, we do not support a whole new integrity provision where the ATO already has a significant number of integrity provisions in the legislation that should cover arrangements of concern. Adding a new provision will simply add to significant compliance costs.

27. We suggest that the ATO could seek to use other anti-avoidance provisions such as section 177EA of the ITAA36 (as referenced in TA 2015/2) or section 202-45(e) if they identify arrangements of concern in the middle market. To the extent that Treasury is aware of deficiencies within those provisions, it would be our strong recommendation that such deficiencies be addressed (rather than adding a whole new section to deal with one single fact pattern).

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[7] At [80].

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Section numbering

28. We make one further final comment and suggest that the measure not be contained in section 207-159. The sections in Subdivision 207-F of the ITAA97 are concerned with situations where no gross-up and or tax offset applies to franked distributions. In particular, subsections 207-145(1) and 207-150(1) contain the operative provisions which switch off the gross-up and tax offset mechanisms for direct and indirect franked distributions respectively.

29. These subsections reference the other sections in the Subdivision (i.e. sections 207-155 to 207-160). However, the distributions are nevertheless considered franked and frankable for the purposes of the Act (e.g. the benchmark rule and the franking account rules).

30. Proposed section 207-159 does not seek to switch off the gross-up and tax offset mechanism for otherwise franked and frankable distributions. Instead, it seeks to make the distribution unfrankable.

31. Therefore, if Treasury is to proceed with this provision, we suggest it is more appropriate to include the measure in some other more appropriate part of the Act, such as in Subdivision 202-C (e.g. as new section 202-48).

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As noted above, we do not agree with the proposed amendments applying to private company groups. We would strongly recommend that Treasury discuss these measures with us prior to implementing this legislation. Please contact either [redacted] on [redacted] or me on [redacted] to discuss this further.

Yours sincerely

[redacted]

A M KOKKINOS
Executive Director