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Dear Sir/Madam

Exposure Draft: Franked distributions and capital raising

PwC appreciates the opportunity to comment on the exposure draft legislation to amend the taxation law to prevent certain distributions that are funded by capital raisings from being frankable.

At the outset, it is our view that the provision as drafted may inadvertently apply to many common capital raising and dividend strategies which are not driven by any tax motives.

Our main comments set out in this submission are summarised as follows:

- If the measure is to apply from the date it was announced, transitional relief should apply to the now almost six-year retrospective period since the measure was first announced, such that it only applies to companies which have entered into arrangements that have the sole or dominant purpose of funding a franked distribution made in the applicable period up until the exposure draft law was released.

- A key priority should be more precision in the legislation as to the parameters of the specific anti-avoidance concern being addressed. The explanatory materials to the proposed law refers to the measure preventing "artificial arrangements" under which capital raised to fund the payment of a franked dividend that would otherwise result in a "manipulation of the imputation system to obtain inappropriate access to franking credits", whereas the proposed law casts a much broader net. For example, the Australian Taxation Office's (**ATO**) Taxpayer Alert TA 2015/2 focusses on companies having substantial franking balances, whilst at a "similar time" raising new capital from existing or new shareholders in a manner which results in (i) a minimal net cash inflow/outflow; (ii) the net asset position of the company remains essentially unchanged; and (iii) there is minimal impact on shareholders, save some receive a refund of franking credits. The examples considered by the ATO in Taxpayer Alert TA 2015/2 related to capital raisings from existing shareholders where the amount of capital raised, dollar for dollar, was then returned to shareholders as a franked dividend. It is these arrangements that should be the focus of the amendments.

- The focus on the "principal effect" or "non-incidental purpose", both before and after the dividend, and in a self-executing provision, will likely cause companies undertaking legitimate capital raising or associated asset sale activities to be caught by these provisions.Given the concern raised by the ATO in TA 2015/2, a more appropriate approach would be to amend existing section 177EA of the *Income Tax Assessment Act 1936* (**ITAA 1936**) - this would allow the measure, with an appropriate discretion given to the Commissioner of Taxation so the provision is not self-executing, to focus on "artificial arrangements" that are designed to release franking credits.

- If proposed subsection 207-159 is to be inserted into the *Income Tax Assessment Act 1997* **(ITAA 1997**) it should explicitly not apply to a distribution made by the entity if it is paid within a certain period of time after the end of its financial year to the extent the distribution is paid out of profits for that year.

- The principal effect test should only apply in the case of equity interests issued by the dividend paying entity or an associate of it or any of its shareholders.

- The purpose test should be reframed as a "sole or dominant purpose" test.

- There is a need for detailed examples in the explanatory materials. PwC would like to arrange a meeting with Treasury to discuss practical examples including dividend reinvestment plans, capital issuances driven by specific reasons (e.g. to acquire an asset or to support a company's balance sheet) and where there is a future change in circumstance that leads the company to wish to return cash to shareholders (e.g. the acquisition does not happen), hybrid equity raisings, equity issuances pursuant to employee share plans etc. We would be happy to prepare a series of examples for discussion with Treasury.

Retrospective application - Transitional relief should apply

We acknowledge that the proposed measure applies to a relevant distribution covered by the provisions that is made at or after 12 noon, by legal time in the Australian Capital Territory, on 19 December 2016 which is in accordance with the original announcement in the Mid-Year Economic and Fiscal Outlook 2016-17.

Although we are not in a position to assess the extent to which the provision may apply across the entire franking entity population, it is expected that there are some companies and shareholders that have made or received affected distributions covered by the new section 207-159, who will be retrospectively impacted by the measure.

A retrospective application of the provision means there is a compliance burden placed on companies to assess whether or not any relevant distributions made during that time were treated as frankable and which had franking credits attached are now taken to be unfrankable. If this is the case, retrospective amendments will be required to the company's franking account (i.e. to reinstate the correct franking debit that arose on the unfrankable distribution). A further consequence might also mean that subsequent frankable distributions that were unfranked or partially franked in fact could have been fully franked with franking credits that become available on the reinstatement of the franking credits on the previous now unfrankable distribution.

Furthermore, if a frankable distribution is retrospectively taken to be unfrankable, this will also require the company to not only communicate with their shareholders and means shareholders will also be faced with the additional compliance burden of needing to amend assessments. In addition, there will be retrospective withholding tax obligations to the extent the now unfrankable dividend was paid to non-resident shareholders.

This exposure draft material is the first opportunity for companies to see the breadth to which this measure might apply to any distributions they have been making since it was first announced, which is almost six years ago.

We submit that a retrospective application of this measure at any time earlier than the date the exposure draft materials were publicly released by Treasury is inequitable, particularly having regard to the compliance burden as noted above and the arrangements most likely targeted (noting that the Commissioner of Taxation still has recourse to the existing section 177EA of the ITAA 1936 in line with the Taxpayer Alert).

If the measure is to continue to apply from its announcement date, we submit that transitional relief apply in respect of distributions made after 12 noon, by legal time in the Australian Capital Territory, on 19 December 2016 until 14 September 2022 (being the date the exposure draft materials were publicly released by Treasury).

Since the measure is designed to prevent artificial and contrived arrangements set up to inappropriately access franking credits that were not intended under the imputation system, we submit that in relation to the transitional period the measure should only apply to distributions made in that period relating to those arrangements that would be entered into for the sole or dominant purpose of funding a franked distribution. This is a reasonable approach given the period of time for which this measure has remained outstanding without any detail other than the original announcement and that any retrospective application does not inappropriately apply to any historical legitimate commercial funding arrangements that might relate to and have the principal effect of funding any distribution or which were not reasonably expected to have potentially been subject to the law as currently drafted.

Affected companies should also be afforded the opportunity to utilise the reinstated franking credits on any subsequent distributions that were made in the transitional period. While the Commissioner of Taxation has discretion to allow the amendment of distribution statements under existing section 202-85 of the ITAA 1997, it would be more equitable that the law is amended to allow distribution statements to increase the franking credits attached for any frankable distributions made in the transitional period where a prior distribution has been taken to be unfrankable by the proposed new section 207-159.

The comment in the explanatory materials at paragraph 1.56 that indicates that allowing arrangements set up to inappropriately access franking credits ".. to continue between announcement and the passage of legislation without any consequences under the law would encourage their use during this period" fails to acknowledge that having regard to Corporations Act 2001, is is not possible to retrospectively make distributions or raise equity.

Scope

As discussed in further detail below, the proposed law is drafted widely and has the potential to inappropriately affect normal commercial capital raising and dividend practices. Although the explanatory materials (paragraph 1.16) make reference to the purpose of the measure being to 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 proposed law does not articulate that object and could potentially apply to cases which are outside of this proposed scope and which are not driven by any tax motives.

The provision is self-activating in that, if the conditions are satisfied, a distribution cannot be a frankable distribution and hence the recipient cannot receive the benefits of franking (i.e. it does not entitle any entity to a franking credit or to a tax offset). We recommend that it may be more appropriate to amend existing section 177EA of the ITAA 1936, with an appropriate discretion given to the Commissioner of Taxation so the provision is not self-executing, to focus on "artificial arrangements" that are designed to release franking credits.

As currently drafted, it is not always apparent whether companies have certainty as to whether or not a particular distribution would be taken to be unfrankable other than in the most blatant or contrived cases. The onus will be on corporate tax entities to prove the rationale for a capital raising was not connected with a special dividend or even a normal dividend for a company that does not have regularity in dividend payments. That is, companies are likely to be faced with the need to seek a ruling from the Commissioner of Taxation before undertaking any capital raising activity and/or when seeking to make frankable distributions. This not only adds to compliance costs, but also will also potentially delay the implementation of the company's capital management or dividend policy.

As currently drafted it is not clear whether the common case of ordinary dividends paid via an underwritten dividend reinvestment plan by a listed company would continue to be frankable distributions (we assume that this fact pattern is fine as it should satisfy the first condition - however, a clear example would be helpful). In the interests of certainty, we submit that the provision should explicitly allow dividend reinvestment plans (both underwritten and non-underwritten), that are implemented as part of an ordinary dividend cycle, to be frankable distributions.

It would be useful for the proposed law or at least the explanatory materials to include some examples of situations where a distribution would be frankable or unfrankable. Examples will significantly assist in understanding the nature of arrangements to which the measure is targeted.

Furthermore, we would encourage the ATO to issue a Law Companion Ruling which would include more detailed examples of scenarios in which the Commissioner would consider that a distribution is frankable or otherwise.

Established practice requirement

A distribution can be taken to be an unfrankable distribution under the proposed measure if the distribution is not consistent with an "established practice" of the entity of making distributions of that kind on a regular basis (proposed section 207-159(1)(a) and (2)). While this drafting would appropriately apply to "distributions declared by a company to its shareholders outside or additional to the company's normal dividend cycle (a special dividend)"[1], it is drafted in wide terms which might inappropriately apply to common cases which are not driven by any tax motives.

In this respect, we note that paragraph 1.24 of the explanatory materials indicates that the "established practice" requirement ensures that the integrity rule does not affect ordinary distributions that have been made on a regular basis and are not made as part of artificial arrangements designed to distribute franking credits to shareholders. We submit that the

[1] Mid-Year Economic and Fiscal Outlook 2016-17: Appendix A Revenue Measures released on 19 December 2016

provision needs to clearly acknowledge and reflect that not all irregularities in distribution practices are designed to manipulate the imputation system to obtain inappropriate access to franking credits.

For example, the current “established practice” limitation appears to inappropriately:

- be biased against private or unlisted companies which tend to make infrequent and irregular distributions to their shareholders as compared to listed companies which are more likely and generally expected to make regular interim and final distributions each year there are profits available
- automatically apply to the dividend component of the buy-back price for companies undertaking an off-market share buy-back, given that off-market buy-backs are not undertaken on a regular basis
- imply that a regular dividend paying company can fund a regular dividend with equity but an infrequent dividend payer cannot fund an infrequent dividend with equity
- fail to recognise that there are instances where a company may have available profits out of which it is making a distribution but does not have immediate cash resources to fund the payment and accordingly needs to raise capital to fund the payment.

Since it is common practice for any company operating in Australia to pay a dividend after the end of its financial year out of the profits from the prior year, we recommend that if the entity cannot otherwise satisfy paragraphs (i) or (ii) of proposed section 207-159(1)(a) (i.e that it has no established regular distribution practice), that the subsection explicitly not apply to a distribution made by the entity if it is paid within a certain period of time (e.g. three months) after the end of its financial year to the extent the distribution is paid out of profits for that year. This is a common scenario that is established practice for companies generally that operate in Australia. This would ensure that the measure is not inappropriately applying to a company that may have ceased the payment of dividends for a number of years due to reduced profitability or losses and have undertaken capital raisings prior to it being in a position to recommence ordinary dividend practices.

The explanatory materials should also make reference to companies which regularly and ordinarily pay interim and final dividends as distinct from a special dividend to which this measure is purportedly targeted.

In addition, we submit that a relevant matter be taken into account that should be listed at proposed section 207-159(2) to be the object of the provision to 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.

Issue of equity

As drafted, the rule can apply where equity is issued in the entity making the distribution or in any other entity (proposed s207-159(1)(b)).

As noted in the explanatory materials, this requirement is broadly drafted. We recommend that the explanatory materials note that the provision can apply to the issue of any equity interest (e.g. as defined in the *Income Tax Assessment Act 1997*) and can apply to the issue of equity without a share issue, i.e. interests that are not traditional “capital raisings”.

The provisions can apply when the entity issuing the equity interests does not have any connection to the entity that has made the distribution. While this might be appropriate in the context of the “purpose” test (in proposed s207-159(1)(c)(ii)), it creates additional uncertainty when considering the indirect funding “principal effect” test (as discussed further below). It is our view that there seems to be no reason why equity issued in any other entity that is not an associate of the dividend paying entity or recipient of the relevant distribution should be captured.

The fact that the equity issue can take place after the distribution is made is likely to lead to significant problems and uncertainty. By way of example, how will a taxpayer be able to provide guidance to shareholders or obtain a ruling on the measure when it is subject to future events and interpretation by the ATO. Although we accept the concern that may still exist we submit that the position in relation to future equity issuances should be limited to the most clear and artificial fact patterns.

Issue of equity interests has the effect or purpose of funding a distribution

Proposed s207-159(1)(c) and (4) requires that it be reasonable to conclude, having regard to all relevant circumstances, the principal effect of the issue of any of the equity interests or the purpose of an entity involved in an issue of equity interests was the direct or indirect funding of all or part of the relevant distribution.

Paragraph 1.32 of the explanatory materials indicate that the principal effect test is satisfied if it is reasonable to conclude the main or most significant consequence of the issue of equity interests was funding the making of some or all of the distributions.

This provision is drafted very broadly and can result in uncertainty in its application, particularly where another entity has issued the equity interest.

For instance, consider the following examples where it would appear that the rule applies as the principal effect of the equity raising would be the indirect funding of the relevant distribution (i.e. as required by paragraph (i) of proposed subsection 207-159(1)(c)), regardless of the purpose of the equity raising:

- Company A is to pay a dividend but needs to borrow funds for such a purpose. If an investor subscribes for shares in Company B which then lends funds at interest to Company A that pays a dividend, it would appear that the rule applies.

- Company X raises equity to fund the acquisition of an asset from Company Y which subsequently pays a special dividend to its shareholders, it would appear that the rule applies as the principal effect of the equity raising would be the indirect funding of the relevant distribution.

This would seem to be the case even if the dividend paying company had no knowledge of the source of the funds that the equity raising company provided to it by way of the share issue and the companies and investor are not associates of each other. It is submitted that the principal effect test should only apply in the case of equity interests issued by the dividend paying entity or an associate of it or any of its shareholders.

Furthermore, we submit that having regard to the objective of the measure to apply to artificial arrangements, that the purpose test in paragraph (ii) of proposed subsection 207-159(1)(c)) should be reframed as a "sole or dominant purpose" test.

We would be happy to discuss these issues with you further. As noted earlier, PwC would like to arrange a meeting with Treasury to discuss practical examples in working through the proposed law.

Yours faithfully

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