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5 October 2022

Director
Corporate Tax Policy Unit
Treasury
Langton Cres
Parkes ACT 2600
By email: frankeddistconsult@treasury.gov.au

Dear Sir/Madam

**EXPOSURE DRAFT**
**TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING) BILL 2022**
**CONSULTATION COMMENTS**

Thank you for allowing me the opportunity to provide feedback on the Exposure Draft ("ED") Legislation in *Treasury Laws Amendment (Measures for a Later Sitting) Bill 2022* ("the ED"). I understand that the ED is a response to (a) Taxpayer Alert 2015/2 and (b) page 112 of the 2016-17 mid-year economic and fiscal outlook. I would be grateful if you would take the following submission into account in finalising the drafting of the legislation.

## 3 CONCERNS

I have 3 concerns with the ED:

1. The ED is seeking to find a solution to a problem which does not appear to exist in the first place.

2. The legislation should not be retrospective.

3. The ED breaches a Labour Party election pledge not to introduce any franking credit amendments.

These matters are discussed below.

## ISSUE 1: POLICY DESIGN ISSUES

I have concerns about a number of policy design issues.

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1. The measures should be targeted at dividends which are not funded out of realised profits.

   Alternatively, the measures should be limited to capital raises where the new investors participate in the dividends and the existing shareholders value the franking credits to a lesser extent than the new investors.

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The payment of a franked dividend requires 2 discrete variables:

1. Realised profits (refer Tax Ruling 2012/5); and

2. A means of funding the payment.

Where profits are realised (ala point 1 above), then corresponding franking credits would generally have been generated by the company. Given that the underlying purpose of the imputation provisions is to prevent double tax at both the company level and the shareholder level, the means of payment (ala point 2 above) is largely irrelevant provided that point 1 is satisfied.

In other words, provided that a dividend is funded out of realised profits, it is largely inconsequential whether a dividend is funded by:

1. A cash payment.

2. An in-specie distribution.

3. A payment followed by a loan back by the shareholder.

4. A dividend funded by borrowings (note that interest on such borrowings would be tax deductible – refer TR 95/25 and *FCT v Roberts; FCT v Smith 92 ATC 4380*).

5. A dividend funded with capital where the new investor does <u>not</u> participate in the dividend.

6. A dividend funded with capital where the new investor <u>participates</u> in the dividend.

7. A dividend reinvestment plan.

All of these 7 funding decisions are ordinary commercial transactions which do not involve imputation manipulation. They are mere funding decisions.

7 practical examples are provided in the Attachment. These 7 examples demonstrate that none of these funding techniques are offensive or result in dividend manipulation.

The measures should therefore exclude dividends which are paid out of realised profits.

Alternatively, the measures should be limited to capital raises where the new investors participate in the dividends and the existing shareholders value the franking credits to a lesser extent than the new investors.

This would ensure that there is a (a) reasonable relationship between the shareholders (or class of shareholders) who derive the profits giving rise to the franking credits and those who receive the franking offsets and (b) a safety mechanism to ensure that there is no substantial dissipation of franking credits away from existing shareholders to new shareholders who are able to obtain a greater benefit from franking credits than the existing shareholders.

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| 2. Purpose test should focus on franking credit dissipation to tax advantaged shareholders. | The purpose test in the ED is focused on whether the principal effect of the issue of any of the equity interests was to directly or indirectly fund some or all of the distribution or where any entity which issued or facilitated the issue of any of the equity interests did so for a purpose (other than an incidental purpose) of funding the distribution or part of the distribution.<br><br>In our view, the purpose test should be aimed at whether a capital raise has facilitated the dissipation of franking credits away from existing shareholders to new shareholders who are able to obtain a greater benefit from franking credits than the existing shareholders. Having said that, we believe that section 177EA already adequately deals with this circumstance. |
| 3. Measures are targeting the wrong taxpayers. | The measures should be aimed at the company paying the dividends, rather than the shareholders. The shareholders are generally unwitting participants who would not have entered into any scheme or tax avoidance arrangement or any imputation manipulation. These mum and dad investors (including superannuation funds and retirees) would generally be nothing more than passive investors who have simply received a franked dividend. They should not have a penalty for being unwitting participants. |
| 4. There should be a deferred franking debit, not an unfranked dividend. | The "punishment should fit the crime". In our view, the measures target (at best) a misdemeanour. The response should therefore be appropriate and proportional. We believe that the appropriate response should be a franking debit for the company paying the dividend.<br><br>However, where the franking debit would otherwise put the company's franking account into a deficit, the debit should be "deferred" (ala subsection 205-30(2)) so that a franking credit will not arise in respect of the payment of a future tax payment until these deferred franking debits are recovered (similar to subsections 205-15(1) and (4)). This would prevent any franking deficits tax from being payable. |

In short, I believe that the proposed legislation is unnecessary because section 177EA adequately deals with any dissipation issues. Alternatively, the legislation should otherwise be better targeted to deal with ensuring that there is:

(a) a reasonable relationship between the shareholders (or class of shareholders) who derive the profits giving rise to the franking credits and those who receive the franking offsets; and

(b) a safety mechanism to ensure that there is no substantial dissipation of franking credits away from existing shareholders to new shareholders who are able to obtain a greater benefit from franking credits than the existing shareholders.

In addition, the sanction should be a franking debit or deferred franking debit.

**ISSUE 2: RETROSPECTIVE LEGISLATION**

Whilst the Government is clearly within its rights to introduce retrospective legislation (refer *R v Kidman* (1915) 20 CLR 42 and *Polyukhovich v The Commonwealth (1991) 172 CLR 50*), I have concerns about the retrospective nature of the legislation.

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| 1. ALR Commission recommends against retrospectivity. | On 31 July 2015, the Australian Law Reform Commission noted that Treasury had previously concluded that tax measures which impose new obligations should generally only apply prospectively. Whilst there are some exceptions *(eg where tax measures address a tax avoidance issue)*, the ED is not an example of such a measure. In fact, the examples in the Attachment show that there is no dividend manipulation even where there is a capital raise. |
| 2. Section 177EA is sufficient. | In our view, there is no basis for retrospective amendment given that there is already an anti-avoidance rule in section 177EA as well as other anti-avoidance rules which adequately deal with any mischief. Section 177EA would be relevant in applying Case Study 6 and prudent taxpayers would seek a ruling from the ATO before entering into such a transaction. |
| 3. Commitment made by previous government. | The earlier announcement (by press release) was made by the previous Government, not by the current Government. It is not appropriate for the current Government to introduce retrospective legislation on the basis of a "piggy back" on a previous Government announcement. |
| 4. Election commitment. | The then Leader of the Opposition, Anthony Albanese, made the following commitment on 2 January 2021 which appears to negate the previous Government's press release:<br><br>"I can confirm that Labor has heard that message clearly and that we will not be taking <u>any changes</u> to franking credits to the next election". |
| 5. Senate standing order. | Senate Standing Order 45 of the Procedural Orders and Resolutions of the Senate of Continuing Effect makes it clear that 6 months, not nearly 7 years, is the maximum acceptable period for retrospectivity. |
| 6. 7 Years to draft a minor amendment | The ED is a very short and simplistic document which would have taken very little time to actually author. If this measure was so pressing and material, then why has it taken nearly 7 years and 3 changes of Government to actually see the light of day? |

In short, I do not believe that the proposed legislation should be retrospective for 7 years. The date of the new measures should be the date the ED was released.

## ISSUE 3: POLITICAL UNDERTAKING

Anthony Albanese, made the following commitment on 2 January 2021:

> "I can confirm that Labor has heard that message clearly and that we will not be taking <u>any changes</u> to franking credits to the next election".

As the legislation breaches this undertaking, the legislation would be a breach of good faith.

I trust that the above comments are sufficient for your present purposes. Please do not hesitate to call me if you would like to discuss this further.

Yours sincerely

Tony Sloan
**Partner - Tax Consulting**

**ATTACHMENT**

**CASE STUDIES WHICH SHOW THAT THE ED MAKES NO SENSE FROM A POLICY PERSPECTIVE**

The following case studies deal with 7 different ways to fund the payment of a dividend.

**Case Study 1: Cash Payment**

CS1 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS1's net assets are $100 (ie $30 + $100 - $30 = $100). CS1 wants to pay out its $70 profit to its shareholders as a franked dividend. CS1 does not have a regular dividend payment policy but has available cash.

Dr Retained Earnings $70
Cr Bank $70

The shareholders are entitled to franking offsets which makes sense.

CS1 is later wound up (all other things being equal).

Dr Issued Capital $30
Cr Bank $30

The existing shareholders get a return of their $30 investment. As there is no economic gain, there is no capital gain for the shareholders. This makes sense.

The imputation system has worked perfectly in this example, as have the capital gains tax provisions.

**Case Study 2: In Specie Distribution**

CS2 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS2's net assets are $100 (ie $30 + $100 - $30 = $100). CS2 wants to pay out its $70 profit to its shareholders as a franked dividend. CS2 does not have a regular dividend payment policy. CS2 has no available cash but it can distribute an investment to its shareholders worth $70.

Dr Retained Earnings $70
Cr Investment $70

The shareholders are entitled to franking offsets which makes sense.

CS2 is later wound up (all other things being equal).

Dr Issued Capital $30
Cr Bank $30

The existing shareholders get a return of their $30 investment. As there is no economic gain, there is no capital gain for the shareholders. This makes sense.

The imputation system has worked perfectly in this example, as have the capital gains tax provisions.

**Case Study 3: Loan Back**

CS3 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS3's net assets are $100 (ie $30 + $100 - $30 = $100). CS3 wants to pay out its $70 profit to its shareholders as a franked dividend. CS3 does not have a regular dividend payment policy. CS3 has no available cash but its shareholders are happy to lend the dividend back to CS3.

Dr Retained Earnings $70
Cr Bank $70

Dr Bank $70
Cr Loan to Shareholders $70

The shareholders are entitled to franking offsets which makes sense.

CS3 is later wound up when its assets are realised (all other things being equal).

Dr Loan to Shareholders $70
Cr Bank $70

Dr Issued Capital $30
Cr Bank $30

The existing shareholders get their loan repaid and a return of their $30 investment. As there is no economic gain, there is no capital gain for the shareholders/lenders. This makes sense.

The imputation system has worked perfectly in this example, as have the capital gains tax provisions.

**Case Study 4: External Loan**

CS4 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS4's net assets are $100 (ie $30 + $100 - $30 = $100). CS4 wants to pay out its $70 profit to its shareholders as a franked dividend. CS4 does not have a regular dividend payment policy. CS4 has no available cash but its funder is willing to lend it $70 to fund the dividend.

Dr Bank $70
Cr Loan Payable $70

Dr Retained Earnings $70
Cr Bank $70

The shareholders are entitled to franking offsets which makes sense.

CS4 is later wound up when its assets are realised (all other things being equal).

Dr Loan Payable $70
Cr Bank $70

Dr Issued Capital $30
Cr Bank $30

The funder gets its loan repaid and the shareholders get a return of their $30 investment. As there is no economic gain, there is no capital gain for the shareholders/lenders. This makes sense.

The imputation system has worked perfectly in this example, as have the capital gains tax provisions.

**Case Study 5: Capital Raise - New Shareholder Does Not Participate in Dividend**

CS5 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS5's net assets are $100 (ie $30 + $100 - $30 = $100). CS5 wants to pay out its $70 profit to its shareholders as a franked dividend. CS5 does not have a regular dividend payment policy. CS5 has no available cash. CS5 is unable to borrow from a bank. However, a new investor (NI) is prepared to provide the funds via a share issue:

Dr Bank $70
Cr Share Capital $70

Dr Retained Earnings $70
Cr Bank $70

NI is not eligible to receive any part of the dividend.

Under the ED, the shareholders are not entitled to franking offsets which makes no sense.

CS5 is later wound up when its assets are realised (all other things being equal).

Dr Issued Capital $100
Cr Bank $100

The existing shareholders get a return of their $30 investment. NI gets a return of its $70 investment. As there is no economic gain for the existing shareholders or for NI, there is no capital gain for the shareholders or for NI. This makes sense.

The imputation system has not worked properly in this example if the ED becomes law. The proposed amendments have distorted and corrupted the tax position for the shareholders, and have thereby undermined the integrity and efficacy of the imputation measures.

**Case Study 6: Capital Raise - New Shareholder Participates in Dividend**

CS6 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS6's net assets are $100 (ie $30 + $100 - $30 = $100). CS6 wants to pay out its $70 profit to its shareholders as a franked dividend. CS6 does not have a regular dividend payment policy. CS6 has no available cash. CS6 is unable to borrow from a bank. However, a new investor (NI) is prepared to provide the funds via a share issue:

Dr Bank $70
Cr Share Capital $70

Dr Retained Earnings $70
Cr Bank $70

NI is eligible to receive part of the dividend.

Under the ED, the shareholders are not entitled to franking offsets which makes no sense.

CS6 is later wound up when its assets are realised (all other things being equal).

Dr Issued Capital $100
Cr Bank $100

The existing shareholders get a return of their $30 investment. NI gets a return of its $70 investment. As there is no economic gain for the existing shareholders or for NI, there is no capital gain for the shareholders or for NI. This makes sense.

The imputation system has not worked properly in this example if the ED becomes law. The proposed amendments have distorted and corrupted the tax position for the shareholders, and have thereby undermined the integrity and efficacy of the imputation measures.

**Case Study 7: Capital Raise - DRP**

CS7 Ltd has $30 of capital. It makes $100 of realised profit and pays $30 of tax. CS7's net assets are $100 (ie $30 + $100 - $30 = $100). CS7 wants to pay out its $70 profit to its shareholders as a franked dividend. CS7 does not have a regular dividend payment policy. CS7 has no available cash. CS7 is unable to borrow from a bank. However, the shareholders will choose to enter into a dividend reinvestment plan:

Dr Retained Earnings $70
Cr Payable to Shareholders $70

Dr Payable to Shareholders $70
Cr Issued Capital $70

NI is eligible to receive the dividend.

Under the ED, the shareholders are not entitled to franking offsets which makes no sense.

CS7 is later wound up when its assets are realised (all other things being equal).

Dr Issued Capital $100
Cr Bank $100

The existing shareholders get a return of their $100 investment. As there is no economic gain for the existing shareholders, there is no capital gain for the shareholders. This makes sense.

The imputation system has not worked properly in this example if the ED becomes law. The proposed amendments have distorted and corrupted the tax position for the shareholders, and have thereby undermined the integrity and efficacy of the imputation measures.

**Nothing Offensive About Case Studies 5, 6 and 7**

The purpose of the imputation system is to prevent double tax, which has occurred in all 7 case studies (including 5, 6 and 7). Given that there are realised profits which have borne tax, why does it matter whether a dividend is funded out of share capital in 5, 6 and 7? This does not have any impact on the integrity of the imputation rules. Therefore, why is there an actual need for the ED?

Perhaps the Government is concerned about Case Study 6 because the new shareholder is receiving some of the franking credits which accrued under the stewardship of the former shareholders. However, even if franking credits were being dissipated in this fashion, Case Study 6 shows that there is no manipulation of the imputation provisions because double tax has been prevented.

Perhaps the Government is concerned about Case Study 6 because franking credits may be dissipated away from existing shareholders who would not get full value for them (eg non-residents) to the new shareholder who may receive a greater benefit. But if this was the real concern of the legislation, why are Examples 5 and 7 also caught? The measures should target this specific dissipation concern, rather than throwing a dragnet over all of the examples.

Specifically, the measures should be limited to capital raises where the new investors participate in the dividends and the existing shareholders value the franking credits to a lesser extent than the new investors.

This would ensure that there is:

(a) A reasonable relationship between the shareholders (or class of shareholders) who derive the profits giving rise to the franking credits and those who receive the franking offsets; and

(b) a safety mechanism to ensure that there is no substantial dissipation of franking credits away from existing shareholders to new shareholders who are able to obtain a greater benefit from franking credits than the existing shareholders.