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To whom it may concern,

Thank you for the opportunity to comment on the Treasury's Exposure Draft Legislation entitled **Treasury Laws Amendment (Measures for a Later Sitting) Bill 2022 (**the **Exposure Draft** or **ED)**.

Please find below a submission by Sandon Capital Pty Ltd (**Sandon Capital**). Hopefully, our submission will help with your aim of ensuring that only objectively sensible legislation is presented to the Australian Parliament for their due consideration.

About Us

Sandon Capital is an investment manager for entities that invest in the Australian share market. Our focus is on medium- to long-term investment returns from investing in undervalued listed companies, using shareholder activism as a tool to positively shape and influence the future direction of these companies. As investors in Australian listed shares, we consider the dividend imputation system a fundamental attraction of investing in Australian dividend paying companies.

Executive Summary

We have three main concerns arising from the Exposure Draft:

- there would appear to be fundamental design flaws in the underlying policy objectives;
- Politically, having the Labor Government attack commercial franked dividend payments runs the risk of voter backlash, particularly after the Labor Party lost the "unlosable" election in 2019 largely as a result of its attack on franking credits in the lead up to that election. The ED would no doubt be painted as "ground hog day" by the Press once the draconian impact of the legislation is made clear on mums and dads, superannuation funds and self-funded retirees; and
- the retrospective nature of the amendments offends public policy.

Issue 1: Policy Design Issues

We have concerns about a number of policy design issues.

Anomalous Impact on Mum and Dad Shareholders and Retirees

By making distributions retrospectively unfrankable back to 2016, the Tax Office would have to amend the assessments of every affected shareholder. For listed companies, there could be thousands of shareholders who are impacted, including mums and dads, retirees, superannuation funds etc.

These shareholders have acted in good faith and have simply invested their hard earned funds in Australian companies. These shareholders have not entered into any scheme or tax avoidance arrangement. They have not manipulated the imputation system. They have been passive investors who have simply received a franked dividend. Furthermore, the application of the legislation, should it be enacted, would mean these shareholders will bear the cost of preparing amended tax returns.

Why should they have a retrospective penalty for being unwitting participants?

Query Policy Integrity

The Exposure Draft Explanatory Materials states that the legislation is an integrity measure

> "*These amendments are an integrity measure. They prevent entities from manipulating the imputation system to obtain inappropriate access to franking credits. They will specifically 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.*"

Unfortunately however, the Explanatory Materials do not articulate how the issue of capital actually "manipulates" the imputation system. Fortunately, Taxpayer Alert 2015/2 throws some light on this issue:

> *"a. there is minimal net cash inflow to or outflow from the company*
>
> *b. the net asset position of the company remains essentially unchanged … but their franking account is significantly reduced, and*
>
> *c. there is minimal impact on the shareholders, except in some cases they may receive refunds of franking credits.*

The franked distributions (or franked component of 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).

The franked distribution may be receivable by all existing shareholders of the company, or shareholders may have a choice as to whether to participate (for example, in a buy-back scenario)."

Having regard to the above "policy considerations", we are concerned that the ED is trying to find a solution to a problem which does not exist in the first place.

In this regard, we note that the main purpose of the imputation system is the prevention of double tax, first at the company level and then at the individual level. Former Prime Minister Paul Keating described the introduction of these double tax relief measures as the most important reform which was introduced whilst he was Treasurer.

We accept that it is possible to inappropriately manipulate the imputation system by streaming franked/unfranked distributions or providing shareholders with choices as to whether to receive franked or unfranked distributions, including pursuant to share buybacks. However, there is already an abundance of adequate anti-avoidance measures which deal with these sorts of issues.

We are therefore struggling to see the perceived mischief which justifies the proposed amendments, particularly when there is no streaming and no choice involved.

Consider the following examples, which are typical of normal commercial transactions:

- **Example 1**

  ABC Ltd has $30 of capital. It makes $100 of profit and pays $30 of tax. ABC's net assets are $100 (ie $30 + $100 - $30 = $100). ABC does not have a regular dividend payment policy and it has no available cash. ABC wants its shareholders to enjoy the franking credits on the profits which they have earned via their patronage during the period that the profits were earned. ABC funds its dividend by borrowing $70 from a bank which will be paid back when ABC realises its assets.

  The shareholders are entitled to franking offsets which makes sense.

  ABC is then wound up. The existing shareholders get a return of their $30 investment. As there is no economic gain, there is no capital gain for the shareholders. Again, this makes sense.

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

- **Example 2**

  XYZ Ltd has $30 of capital. It makes $100 of profit and pays $30 of tax. XYZ's net assets are $100 (ie $30 + $100 - $30 = $100). XYZ does not have a regular dividend payment policy and it has no available cash. XYZ wants its shareholders to enjoy the franking credits on the profits which they have earned via their patronage during the period that the profits were earned. XYZ is unable to borrow from a bank. However, a new investor (H) is prepared to provide the funds via a share issue of $70.

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

  XYZ is then wound up. The existing shareholders get a return of their $30 investment. H gets a return of its investment of $70. As there is no economic gain for the existing shareholders or for H, there is no capital gain for the shareholders or for H. Again, this makes sense.

  The imputation system has <u>not</u> 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.

What is offensive about Example 2?

In our view, nothing. Example 2 is entirely consistent with the imputation system. The only difference between Example 1 and Example 2 is that XYZ's net assets are higher than ABC's net assets. But so what? The purpose of the imputation system is to prevent double tax, which has occurred. Why does it matter whether a dividend is funded out of debt or equity? This does not have any impact on the integrity of the imputation system. Therefore, why is there a need for the ED?

Perhaps the ED should be better targeted to particular types of transactions which actually compromise the intended operation of the imputation system. Having said that, we believe that the existing rules in section 177EA and the other anti-avoidance rules (eg Subdivision 207-F) already adequately cater for these circumstances.

To reiterate, we are concerned that the ED is trying to find a solution to a problem which does not exist in the first place or is otherwise "over-reaching" beyond that which makes objective sense.

ED Should be Limited to Streaming/Choices

We believe that the imputation legislation should:

(a) Promote the overall intention of the imputation system which is to prevent double tax; and

(b) Ensure that inappropriate streaming or choices do not undermine the general requirement that there be 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.

In our view, the ED does not achieve either point (a) or point (b). Indeed, the examples above show that the ED would actually create incongruous, anomalous and unintended cracks and gaps in the imputation framework.

Purpose Test

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.

In our view, the purpose test should be aimed at whether there is a franking credit manipulation purpose, <u>not</u> on whether the capital raise facilitates the actual payment of the distribution. Example 2 above clearly show that the there is nothing sinister about the raising of capital to fund a dividend payment *simpliciter*.

The purpose test should therefore be redrafted so that it tests whether there is a reasonable relationship between the shareholders (or the general class of shareholders) who derive the profits giving rise to the franking credits and those who receive the franking offsets.

If this was the test, the shareholders in Example 2 would not be unfairly disadvantaged over the shareholders in Example 1.

Funding of Dividends is Not Relevant

There are essentially 5 ways for a company to fund the payment of a dividend:

1. A payment out of existing working capital (ie a distribution of cash/property).
2. A payment followed by a loan back by the shareholder.
3. A dividend reinvestment plan.

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

5. A dividend funded with capital.

Points 2-5 essentially occur where the company wants to pay a dividend but they do not have the immediate working capital to fund the payment. Therefore, the company seeks external funding to satisfy its funding gap.

In our view, all of these funding arrangements are ordinary commercial transactions and they do not have anything to do with imputation manipulation. They are nothing more than funding decisions.

In our view, the ED indiscriminately, aimlessly and arbitrarily attacks point 5 (and potentially point 3).

Example 2 above – which is a very common example in practice - clearly shows that franked dividends can be paid in conjunction with a capital raise without creating any franking manipulation or other tax distortions. In fact, Example 2 clearly illustrates that such a transaction helps promote the underlying policy of the imputation system, which is to prevent double tax.

The Paradox of Extrapolation

We are concerned that the ED is a "knee jerk" reaction. It is as if someone has historically stumbled across a franked distribution connected with a capital raise which, and solely because of its unique and blatant features, was an inappropriate franking outcome <u>in that particular case</u>.

This possibly unique case study has been <u>extrapolated</u> to ALL franked dividends/capital raises and has been used to convince other government that a blanket prohibition should be introduced.

Put another way, we believe that the ED is the unfortunate product of the someone acting like the Pied Piper of Hamelin luring unsuspecting ATO officers/Ministers into believing that a random tax avoidance example should be extrapolated into a general clamp down on a commercial practice by labelling the entire practice as "imputation manipulation". The dulcet tones of alleged tax avoidance resonating from the Piper's magic flute must be particularly attractive at a time when budgetary pressures abound.

Example 2 above – which is a very common example in practice - clearly shows that franked dividends can be paid in conjunction with a capital raise without creating any franking manipulation or other tax distortions. In fact, Example 2 clearly illustrates that such a transaction helps promote the underlying policy of the imputation system, which is to prevent double tax.

Therefore, we believe that the hypnotic seduction by the magic flute should be replaced by a clinical objective assessment of whether there is actually an avoidance issue in the first place.

Specifically, we believe that the ED should be better targeted to capital raises that actually compromise the intended operation of the imputation system. Having said that, we believe that the existing rules in section 177EA and the other anti-avoidance rules (eg Subdivision 207-F) already adequately cater for these circumstances.

To reiterate, we are concerned that the ED is trying to find a solution to a problem which does not exist in the first place or is otherwise "over-reaching" beyond that which makes objective sense.

Issue 2: Political Suicide Mission

The Labor Party and franking credits are not friends.

As you will no doubt recall, the then opposition leader, Bill Shorten, attempted to bring in franking credit amendments as part of Labor's 2019 election. Suffice to say that the franking amendments were a large reason that Labor lost that "unlosable election".

Indeed, on 19 May 2019, Jenna Clarke wrote in *The West Australian* that:

> "*Labor learned last night that hell hath no fury like older Australians at risk of losing their franking credits. Labor insiders admitted the policy to remove generous share tax refunds — paid mostly to retirees — was "killing us" in Queensland and New South Wales. It was the unlosable election and Bill Shorten and his band of merry, progressive men and women fluffed it. It was the US presidential race of 2016 and 'Bill Shorten' blew it."*

On 26 May 2019, Eryk Bagshaw wrote in *The Canberra Times* that:

> "***Federal election 2019: Massive swings against Labor in franking credit seats***
>
> *Labor was hit with swings of up to 15 per cent against it in polling booths where people aged over 60 made up more than 15 per cent of the voters, new figures show, revealing the impact of the party's controversial franking credit platform.*
>
> *Labor MP Mike Kelly has [used the figures to] urged the party to consider dumping the current policy settings, saying it should be "grandfathered or include relief for low income earners" in the wake of the election result. "I heard it loud and clear," he said.*
>
> *The policy helped lose Bill Shorten the election on Saturday - as retirees down the east coast protested the $6 billion-a-year move to strip them and their families of tax refunds.*

> *… The policy was dismantled through a "retiree tax" campaign run by Liberal MP Tim Wilson and the founder of Wilson Asset Management Geoff Wilson*."

In fact, Bill Shorten acknowledged that political mistake on 6 October 2019 where he stated that:

> "*We misread the mood about franking credits". "In hindsight there were a lot of people who felt vulnerable."*

With the 2019 franking credit election miscalculation clearly in his memory, the then Leader of the Opposition, 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*".

We do not consider that the Labor Government would view Treasury in a favourable light if it enabled the introduction of retrospective (or indeed prospective) franking legislation which encouraged the Press to re-open its "retiree tax" mantra. After all, it could well result in the loss of another "unlosable" election for the Labor Party come the next election.

Issue 3: Retrospective Element

Government Has a Right to Introduce Retrospective Legislation

The ED makes the legislation retrospective going back nearly 7 years:

> "*The substantive amendments made by Schedule # apply to distributions made on or after 12 pm, by legal time in the Australian Capital Territory, on 19 December 2016*."

We acknowledge that the Australian Parliament has a clear right to make retrospective legislation. Perhaps the most well-known retrospective law is the *War Crimes Act 1945* (Cth), which was amended by the *War Crimes (Amendment) Act 1988* (Cth).

However, notwithstanding the Australian Parliament's *dejure* power to introduce retrospective legislation, we believe that it is incumbent on Treasury to provide wise counsel and advise the Government against the use of such extreme practices where, as in this case, such practices are unjust, unfair, prejudicial and discriminatory and would be frowned upon by the public at large (including the voting public).

Put simply, where "the man in the street" would view retrospective legislation as an inappropriate, improper and misplaced use of executive power, which would otherwise offend public confidence and undermine democratic values upon which the rule of law is based, Treasury should take the high moral ground and strongly advise and recommend for the prospective application of the legislation only.

Judicial Concerns Re Retrospectivity

In this regard, we note that there is no novelty in the proposition that retrospectivity should be an extreme exception (ie a last resort). Way back in 1923 in *George Hudson Ltd v Australian Timber Workers' Union* (1923) 32 CLR 413, Isaacs J quoted the 6th edition of *Maxwell on Statutes*, which in turn referred to the Institutes for the proposition that:

> "*Upon the presumption that the Legislature does not intend what is unjust rests the leaning against giving certain statutes a retrospective operation.*"

Isaacs J described that proposition as:

> "*the universal touchstone for the Court to apply to any given case*."

More than 70 years later, Lord Mustill in *L'Office Cherifien des Phosphates v Yamashita-Shinnihon Steamship Co Ltd* [1994] 1 AC 486 at 525 said of the presumption against retrospective construction:

> "*the basis of the rule is no more than simple fairness, which ought to be the basis of every legal rule*"

Cases such as *Polyukhovich v The Commonwealth (1991) 172 CLR 50* also make it clear that retrospective legislation could undermine a public interest. In that case, Toohey J stated:

> "*Prohibition against retroactive laws protects a particular accused against potentially capricious state action. But the principle also represents a protection of a public interest. This is so, first, in the sense that every individual is, by the principle, assured that no future retribution by society can occur except by reference to rules presently known; and secondly, it serves to promote a just society by encouraging a climate of security and humanity.*"

More recently, in *Australian Education Union v Fair Work Australia* (2012) 246 CLR 117 at [28], the High Court (French CJ, Crennan and Kiefel JJ citing Isaacs J and 6th edition of *Maxwell on Statutes*) cautioned against retrospective legislation which may interfere with vested rights or make unlawful conduct which was lawful when done. Indeed, the presumption against retrospective statutory construction is based on 'the presumption that the Legislature does not intend what is unjust'.

> "*In a representative democracy governed by the rule of law, it can be assumed that clear language will be used by the Parliament in enacting a statute which falsifies, retroactively, existing legal rules upon which people have ordered their affairs, exercised their rights and incurred liabilities and obligations. That assumption can be viewed as an aspect of the principle of legality, which also applies the constructional assumption that Parliament will use clear language if it intends to overthrow fundamental principles, infringe rights, or depart from the general system of law.*"

In *Director of Public Prosecutions (Cth) v Keating* (2013) 248 CLR 459, a majority of the High Court emphasised the common law principle that the criminal law 'should be certain and its reach ascertainable by those who are subject to it'. This concept is 'fundamental to criminal responsibility' and 'underpins the strength of the presumption against retrospectivity in the interpretation of statutes that impose criminal liability'. The High Court went on to cite *Bennion on Statutory Interpretation*:

> "*A person cannot rely on ignorance of the law and is required to obey the law. It follows that he or she should be able to trust the law and that it should be predictable. A law that is altered retrospectively cannot be predicted. If the alteration is substantive it is therefore likely to be unjust. It is presumed that Parliament does not intend to act unjustly.*"

Whilst some of the above comments were made in the context of criminal law, the comments are nevertheless still germanane to the retrospective nature of the ED.

Best Practice is Not to Introduce Retrospective Legislation

On 31 July 2015, the Australian Law Reform Commission stated[1] that:

> "*9.53 In 2004, a Treasury Department review of aspects of income tax self-assessment considered suggestions that Parliament should not pass retrospective tax laws. The review concluded that the commencement date of measures should remain an issue to be 'examined and determined by Parliament on a measure-by-measure basis'.*
>
> *9.54 The review stated that while, ideally, tax measures imposing new obligations should apply prospectively, retrospective commencement dates may be appropriate where a provision:*

[1] Refer https://www.alrc.gov.au/publication/traditional-rights-and-freedoms-encroachments-by-commonwealth-laws-alrc-interim-report-127/9-retrospective-laws/laws-with-retrospective-operation/

- *corrects an 'unintended consequence' of a provision and the ATO or taxpayers have applied the law as intended;*
- *addresses a tax avoidance issue; or*
- *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.*"

In our view, there is no basis for retrospective amendment given that there is already an anti-avoidance rule in section 177EA of the *Income Tax Assessment Act 1936* as well as other anti-avoidance rules which adequately deal with any mischief.

Moreover, the earlier announcement (by press release) was made by the previous Government, not by the current Government.

In any event, the then Leader of the Opposition, Anthony Albanese, made the following commitment on 2 January 2021 which negates (or trumps) the previous press release:

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

The Pub Test

We made the comment above that we believe that it is incumbent on Treasury to provide wise counsel and advise the Government against the use of retrospective legislation and that such practices are generally frowned upon by the public at large (including the voting public).

For example, back on 9 June 1983, when the Senate rejected the Labor Government's retrospective tax legislation, the press was scathing about the audacity of the retrospective proposals:

> *"'The new legislation drives the thin edge of the retrospectivity wedge beyond its legitimate target. It is too broad; it would hit some people unfairly." (*The Age, 27 May 1983*).*

> *"To widen the net, as did the new Government, to allow the retrospectivity clauses to encompass people who worked openly within the law as it stood is to allow the need for funds to go beyond reasonable bounds." (*Launceston Examiner, 3 June 1983*)*

> *"The Bill was basically unfair in that it went far beyond recovering company tax evaded in bottom-of-the-harbour operations." (*West Australian, 4 June 1983*)*

> *"If the Senate had not defeated the tax bill put to it by the Federal Government this week, it would have allowed a serious injury to be done to our democratic system." (*The Australian, 4 June 1983*)*
>
> *"It would have breached a sound principle that governments should not impose penalties with retrospective laws ... the defeat of the tax legislation last week was the best outcome." (*The *Adelaide Advertiser, 6 June 1983)*
>
> *"While retrospective legislation is justifiable to recoup tax that has been fraudulently evaded, it is not acceptable when it seeks to impose a capital gains tax by backdoor methods." (The Age, 6 June 1983)*

The ED is another example of retrospective legislation which would not pass the pub test.

7 Years Too Long

Apart from our general view that the proposed legislation should not be retrospective, it should certainly not be retrospective back nearly 7 years.

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:

> "***45 Taxation bills – retrospectivity***
>
> *Where the government has announced, by press release, its intention to introduce a bill to amend taxation law, and that bill has not been introduced into the Parliament or made available by way of publication of a draft bill within 6 calendar months after the date of that announcement, the Senate shall, subject to any further resolution, amend the bill to provide that the commencement date of the bill shall be a date that is no earlier than either the date of introduction of the bill into the Parliament or the date of publication of the draft bill."*

We would therefore expect the Senate to intervene if the ED is made retrospective, as is currently intended.

As noted above, the then Leader of the Opposition, Anthony Albanese, made a commitment on 2 January 2021 that "*we will not be taking <u>any changes</u> to franking credits to the next election*". In the context of such an explicit "U-Turn" in tax policy, it is hard to see that a 7 year retrospective "club" would be anything other than an inappropriate use of executive power.

It is also hard to see a justification for retrospectivity when the ED, which is a very short and simplistic document which would have taken very little time to actually author, has taken nearly 7 years and 3 changes of Government to actually see the light of day.

How can the Government credibly argue that retrospectivity is appropriate when the gestation period of the ED is so manifestly disproportional? After all, if the issue was so pressing and material, then why has it been sitting on someone's in-tray for over two-thirds of a decade. It makes no sense.

Conclusion

For the reasons discussed above:

1. We do not believe that the proposed legislation should be retrospective.

2. We do not believe that the proposed legislation should be retrospective for 7 years (the date of the release of the ED should be the application date).

3. We consider that there are adequate existing anti-avoidance measures in place to ensure that the policy objectives are met.

We thank the treasury for the consideration of our perspective. If you have any questions or would like to discuss this response to the Consultation Paper, please do not hesitate to contact me.

Yours sincerely,

Gabriel Radzyminski
Director, Sandon Capital Pty Ltd