The Tax Institute

10 October 2022

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

Dear Director,

Franked distributions and capital raising

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings exposure draft legislation (**exposure draft**) and explanatory materials.

In the development of this submission, we have closely consulted with our National Small and Medium Enterprise Technical Committee and our National Large Business and International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The Tax Institute broadly supports the policy intention of the exposure draft and explanatory materials, to ensure that entities cannot receive franking credit benefits where there is a contrived arrangement to derive franking credits from unfrankable distributions. However, we consider that the exposure draft and explanatory materials extend well beyond the initial scope of the Mid-Year Economic and Fiscal Outlook 2016-17 (**MYEFO announcement**), and does not address the matters contemplated by Taxpayer Alert TA 2015/2 Franked distributions funded by raising capital to release franking credits to shareholders (**TA 2015/2**) in an appropriately targeted manner.

The exposure draft and explanatory material are intended to implement an integrity measure to deter particular contrived arrangements. However, the measure appears to inadvertently capture a number of transactions and taxpayers, that may be unfairly penalised. We have proposed a number of recommendations to ensure that the proposed measure appropriately targets only those cases contrived to inappropriately benefit from franking credits.

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We consider that the exposure draft should be amended to ensure it appropriately targets the intended mischief. To achieve this, we recommend that the scope and operation of the principal effect and purpose tests be narrowed from the current broad application, with guidance in the explanatory material outlining the specific circumstances in which the tests will be satisfied. Further, both tests should be required to be met before the proposed measure will apply. Without these changes, the proposed measure will inadvertently encompass ordinary commercial dealings and low-risk arrangements.

The Tax Institute also has significant concerns regarding the retrospective nature of the exposure draft and is of the view that it should only apply to arrangements entered into after the legislation receives royal assent.

The measure has broad implications across the tax community, that may cost the tax system more to administer than the $10 million revenue it is expected to generate. Many businesses, ranging from small private groups to large publicly listed groups, may be caught by these provisions and subject to the onerous task of identifying and analysing historical transactions in circumstances where there has been no artificial arrangement to receive a franking credit benefit but the provisions are nonetheless satisfied.

As a broader implication, the proposed measure may deter businesses from undertaking corporate restructures, implementing succession planning strategies, and potentially other low-risk activities that are commercial in nature.

Our detailed response is contained in **Appendix A**.

We consider that it would be beneficial to hold a roundtable discussion involving members of The Tax Institute and the Treasury, to urgently discuss the matters outlined in this submission and the practical implications of the proposed measure for all businesses across Australia.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

Yours faithfully,

Jerome Tse

President

APPENDIX A

We have set out below our detailed comments and observations for your consideration to ensure that the proposed measure is effective in meeting its policy intent. Our comments broadly follow the layout of the explanatory materials, followed by our additional comments.

All section references are to the exposure draft and paragraph references are to the explanatory materials unless otherwise indicated.

Scope of the proposed new law

TA 2015/2 intended to address artificial arrangements undertaken by certain groups to derive franking credit benefits. In the MYEFO announcement, the previous Government stated its intention to introduce a measure to address the issues raised in TA 2015/2, specifically targeting special dividends issued to shareholders and accompanied by capital raisings. Examples of the types of capital raising activities contemplated in the MYEFO announcement included underwritten dividend reinvestment plans and placements/underwritten rights issues.

However, the scope of the exposure draft and explanatory materials extend beyond the initial policy intent in several ways. The proposed measure encompasses a broader range of distributions from the initial policy intent and can be easily satisfied by businesses such as small private groups whose distributions and transactions may not necessarily adhere to the regularity these provisions require. The exposure draft may also potentially impact common and commercial activities undertaken by many businesses, such as employee share schemes (**ESS**) and dividend reinvestment plans (**DRPs**).

The scope of the exposure draft could deter businesses from undertaking these types of transactions, potentially impacting investment into businesses and their growth. Noting that the measure is estimated to raise approximately $10 million per year over the forward estimates period[1], there is a significant concern that the relatively small amount of revenue expected to be collected will have a disproportionate economic impact and significantly increase compliance costs for businesses.

We recommend that the Government reconsider the scope of the proposed measure and ensure it only targets the small category of transactions that are contrived to benefit from franking credits.

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[1] Mid-Year Economic and Fiscal Outlook 2016-17, page 112.

Explanation of the new law

We consider that the explanatory materials should contain information on the reason for the amendments. Paragraph 1.16 states that the amendments are an integrity measure to prevent the manipulation of the imputation system. However, there are already a number of integrity provisions contained in the tax legislation which address tax avoidance and several specifically related to distributions. These include, but are not limited to, the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**), section 177EA of the ITAA 1936 and the anti-streaming rules in Division 204 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). As the measure is proposed to apply retrospectively and has a broad scope and implications, it is crucial that the explanatory materials contain detailed guidance on the perceived gap this integrity provision will fill.

Established practice

The MYEFO announcement specifically targeted 'special dividends' to the extent they were funded directly or indirectly by capital raising activities. Paragraphs section 207-159(1)(a) and (b) attempt to provide criteria that will capture 'special dividends'. However, this results in a widening of the scope of the measure to apply to many common arrangements. We consider that as the tax law does not contain a definition for 'special dividend', of which the MYEFO announcement refers to, it would be helpful to explicitly define and limit this term in the exposure draft. It would also assist to include examples that would fall within scope and those that would not.

Small and medium private groups

The established practice requirement is satisfied where the entity's distribution is 'outside the normal cycle' for the entity or where there is no established practice of distributions. This can be very easily satisfied by private groups that do not have a normal practice of paying regular distributions, as the payment of distributions is often dependent on current trading performance, business cashflow and owners' personal cash requirements. These factors can often result in the timing and amount of distributions varying considerably.

We understand from our members that it is common practice for private companies to pay out a substantial portion of retained earnings as dividends prior to an equity event in order to:

- reflect the existing shareholders expectation/entitlement to the earnings accumulated to the date of entry of a new shareholder; or
- reduce the entry price for new shareholders/employee share schemes, to make the investment more affordable for the new entrant.

The above practice could satisfy the requirements of the proposed measure, even though the purpose of the distribution is to facilitate a change in ownership rather than to manipulate the imputation system.

The proposed measure is likely to have a significant impact on private groups by creating additional uncertainty around private company investment transactions. Affected taxpayers are also likely to incur additional compliance costs in reviewing the transactions executed over the six years since the MYEFO announcement. The proposed measure could create a barrier to succession planning for small and medium sized private groups, especially where ESSs or similar programmes are used to facilitate a change of ownership. Please refer below to our comments below on ESSs for further detail.

Disregarding previous distributions from an established practice

Subsection 207-159(3) provides that previous distributions funded by equity are to be disregarded for the purposes of paragraph 207-159(1)(a). This is elaborated on in paragraph 1.23 which provides that taxpayers are prevented from benefitting from any historical 'mischief' the amendments seek to prevent. We consider that the disregarded historical distributions could be part of a pattern of distributions and by ignoring these payments it may result in certain distributions unfairly being caught by the amendments.

For example, where DRPs were offered prior to 19 December 2016, the amendments would not apply to these DRPs. However, DRPs offered from the MYEFO announcement date could be caught by these provisions and may be excluded from establishing the practice of distributions. The exclusion of the DRPs paid between 19 December 2016 and the commencement measure, could result in future DRPs or dividends not satisfying the established pattern condition in paragraph 207-159(1)(a) due to the disregarded DRPs. Please see below for further comments on DRPs.

Issue of equity interests

Paragraphs 1.25 and 1.26 explain that the requirement that there has been an issue of equity interests, can be applied broadly. The equity issue does not have to occur at the same time as the distribution but can be beforehand or afterwards. There is no requirement for a connection between the entity issuing the interest and the entity paying the distribution. For example, where a company is being sold and pays a pre-sale dividend, such a dividend may be funded from capital provided by the purchaser, which may in turn have been raised through the issue of equity interests by the purchaser.

We consider that this scope is too broad and will capture many distributions that were not intended under the original policy intent. The explanatory materials do not define a timeframe for when a capital raising will be considered independent of the payment of a distribution. We consider that the nexus provision should be redrafted in a way that is more targeted and that the explanatory materials should provide guidance on the timing between the distribution and capital raising that will be deemed unrelated as well as the circumstances to which this measure will not apply.

We have set out below some common scenarios may trigger the application of the measure as currently drafted, irrespective of a lack of intent to derive an inappropriate benefit.

Dividend reinvestment plans

Subparagraph 207-159(1)(c)(i) is likely to capture DRPs as the principal effect of an issue under a DRP is to fund the dividend distribution. Only where there was an established pattern of dividend reinvestment, would the DRP not be considered an unfranked distribution. Paragraph 1.20 states that if an entity has never previously made a distribution, the entity will not have a practice of making distributions. This would therefore capture dividends paid under DRPs that were not in existence prior to 19 December 2016 as the company would not be able to satisfy the established practice requirement.

A DRP generally provides investors with a cost-effective and easy method to acquire more equity in an investment. If DRPs are included in this measure, entities may be disincentivised from offering them to investors. Additionally, where an option to opt-in to a DRP is available, those taxpayers opting-in may be disadvantaged as they may not receive the additional franking credits, compared to those opting-out of the DRP. This may disadvantage taxpayers who rely on DRPs to affordably acquire a greater number of equity interests. Accordingly, we recommend that DRPs are specifically excluded from the operation of this measure, as the benefit of a DRP is often not for financing via equity issue, rather it enables existing investors to derive a benefit through reduced costs of the equity.

Share buy backs

Share buy backs are generally undertaken by entities for purposes that include consolidating ownership, improving financial ratios and creating value for their shareholders. We are concerned that, as currently drafted, share buy backs may be caught by the provisions due to the potential deemed nexus between the timing of a distribution and the issue of capital. We recommend that share buy backs should generally be excluded from these measures unless there is a contrived arrangement to derive a franking credit benefit.

The explanatory materials should clarify the exclusion of share buy backs from this measure through examples where arrangements are included or excluded from the scope of the measure. For example, Company A has bought back its shares from Shareholder A. Subsequent to (or contemporaneously with) the buy back, other shareholders lend Company A money on an at call basis (which is treated as equity under the debt/equity rules) or subscribe for further capital to facilitate the buy back or to replenish funds used to buy back the shares. In this scenario there is no artificial arrangement to derive a franking credit benefit. Rather it demonstrates an example of commercial transactions that provide a potential advantageous funding arrangement.

Employee share schemes

We consider that ESSs should not be captured by the scope of these amendments. Many employers use ESSs to attract, retain and motivate employees. With the issuance of equity being broadly applied to arrangements, ESSs could be captured despite the ESS and distribution not being part of a contrived arrangement. We recommend that the measure explicitly exclude ESSs from being arrangements to issue equity for the purposes of this measure.

Timing

Paragraphs 1.38 and 1.39 highlight that timing is a factor to consider. However, it is unlikely to be determinative as delaying the capital raising or raising an amount different to the distribution will not prevent the amount from meeting the purpose or effect test, if the other factors indicate the relevant threshold has been met. The Tax Institute has concerns that this factor is too broad and too easy to satisfy. There is no guidance regarding what period of time may be indicative of the purpose or effect tests not being satisfied. The current wording of the explanatory materials appears to indicate that the timing factor will always be met. We consider that the explanatory materials should be updated to provide further guidance on the instances that are likely to indicate that the timing factor has not been met. This will provide taxpayers with further guidance on the scope of the proposed measure.

Purpose or effect of the issue of equity interests

Paragraph 207-159(1)(c) of the exposure draft introduces a new type of test, a 'principal effect' test, in addition to a purpose test. Paragraph 1.34 of the explanatory materials suggests the principal effect test focuses on the outcome, whereas the purpose test is satisfied by ascertaining the intention, and that in many cases, the outcome of both tests would be the same. The exposure draft requires that only one of the tests is met for the measure to apply. However, we are concerned that either or both of the tests could be easily satisfied even in instances where genuine activities are conducted by the entity.

Principal effect test

The principal effect test is based on a similar test contained in Subdivision 165-A of *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**) which sets out when the anti-avoidance provision operates. Subdivision 165-A not only requires the principal effect of a GST benefit for the anti-avoidance provision to operate, but the principal effect is a result or a part of a scheme. In comparison, the principal effect contained in the exposure draft and explanatory materials, can operate irrespective of an intention by the entity to obtain a benefit by raising capital to fund a distribution.

The principal effect test may apply to a broad range of transactions, especially through its application to the indirect funding of distributions. This test could apply in a scenario where a company raises equity and on-lends the raised funds to an unrelated party that uses those borrowed funds to pay a dividend. In this scenario, the principal effect test would be satisfied, and the shareholders of the unrelated party would be denied franking credits, irrespective that the unrelated party did not intend to fund the distribution by a capital raising.

The principal effect test could also be satisfied in instances where equity is raised for normal business reasons that happen to coincide with a distribution of franked dividends. For example, a company may issue equity primarily to raise funds for the purchase of an asset that will be utilised by the business. Although this is ordinarily a commercial choice of funding by the company, if accompanied by a distribution around the same time, the business is likely to meet the principal effect test.

As stated in paragraph 1.16 of the explanatory materials, the intention of the integrity measure is to specifically prevent artificial arrangements or a manipulation of the imputation system. We consider that a manipulation generally requires deliberate action to be undertaken and cannot be evidenced by solely considering an outcome of a transaction. The principal effect test requires an assessment of the outcome without consideration of the actions which resulted in the outcome. We consider that looking only at the outcome does not appropriately reflect the policy intent of the measure as it cannot be reasonably concluded if there was manipulation of the imputation system to achieve the relevant outcome.

Accordingly, we recommend that the principal effect test is removed from the proposed measure. If it is to be retained, we consider that both the principal effect test and purpose test should be required to be satisfied (and not only one of those tests) to ensure that only contrived arrangements to derive inappropriate franking credit benefits are captured by the proposed integrity measure.

Purpose test

We consider that the operation of subparagraph 207-159(c)(ii) and understanding by taxpayers and advisers could be improved through the explanation of terms in the explanatory materials. The explanatory materials refer frequently to manipulating the imputation system to obtain inappropriate access to franking credits and preventing the use of artificial arrangements under which capital is raised. However, the exposure draft does not include these objects. Rather, paragraph 1.33 states that the purpose test could be satisfied when the intention to issue capital to fund a distribution is 'more than incidental to some other purpose'. A more than incidental purpose, does not necessarily translate to an egregious arrangement. We consider that this threshold is too low, especially where there could be multiple purposes behind the arrangement and the issuing of equity to fund distributions could be a minor consideration. We recommend that the purpose test be reworded to include the objects of the policy intent and require the objects to be a key purpose of the arrangement. Alternatively, the threshold should be raised to require the objects be the sole or dominant purpose of the arrangement. This would be consistent with the purpose threshold for section 177D of the ITAA 1936 and ensure that the proposed measure only targets the arrangements intended in the MYEFO announcement.

Paragraph 1.33 also provides examples of advisers and related parties of the entity, as being other parties, whose purpose could be taken into account. However, this could also extend to unrelated parties. Where the conditions are satisfied, the entity and its taxpayers will be subject to franking credit denial. If the purpose test is satisfied by an external party, there is a possibility that the promoter penalty regime in Division 290 of Schedule 1 to the *Taxation Administration Act 1953* will apply. In these circumstances the proposed measure will, arguably, not need to apply to the external party. We consider that the explanatory materials should provide further guidance regarding the interaction between the proposed measure and the promoter penalties regime.

Entire distribution unfrankable if the test is satisfied in relation to part of a distribution

Paragraph 1.36 of the explanatory materials states that the entirety of a distribution will be unfrankable where the test is satisfied in relation to part or all of the capital raised. This would mean that where even an immaterial proportion (e.g. 5 percent) of a distribution is deemed to be funded by an equity issue, 100 percent of the franking credits attached to the distribution would be denied. This is, in our view, a disproportionate and punitive outcome, especially in consideration of the proposed retrospective application.

Corporate groups may contain different classes of shares which could result in distributions being funded by differently. It is unclear whether the meaning of 'entire distribution' would be confined to a particular shareholder or the entire distribution to all shareholders, where a distribution to some shareholders is deemed to be funded by an equity issue, but the distribution to other shareholders is not.

In our view, the unfrankable amount of a distribution should be limited to the portion of the distribution deemed to have been funded by an equity issue for the purpose of obtaining the benefit of the franking credits. Where a taxpayer has implemented an arrangement to pay part of a distribution from equity funding, the explanatory materials should provide a methodology to easily calculate the unfrankable portion of the distribution. We consider that by apportioning the franking credit denial to the 'tainted' distribution and by providing taxpayers with a mechanism to ascertain the impact of the capital raising, affected taxpayers will be more willing to proactively apply the measures.

Use of funds

Paragraph 1.43 indicates that use of the funds, even if not used immediately for a distribution, will often be a significant in determining the purpose and effect tests. Further, the purpose test may be met if the raised funds are quarantined and other funds are freed for the purpose of the making a distribution. We consider this to be too broad in scope. Businesses, especially large and publicly listed companies, regularly undertake several raising and spending activities at any given time.

By way of example, feedback from our members suggests that it is not uncommon for businesses to pay a special dividend during periods of extraordinary profits or growth. This can often occur in certain sectors such as the mining and resources industry during mining or resources 'booms'. Special dividends are often treated as a singular event owing to the surrounding circumstances and are not intended to 'reset' the shareholders' expectations about future dividends. In these circumstances, a company paying a special dividend that also undertakes a capital raising activity for an unrelated transaction, for example an M&A transaction involving scrip for scrip, could inadvertently trigger the proposed rules. This may be the case even where the two activities were undertaken pursuant to separate commercial considerations and objectives. From a practical perspective, it will be difficult for the company to demonstrate that funds from the capital raising activity were not used in any way, or quarantined allowing other funds to be used, for the special dividend.

As demonstrated by the various examples in our submission, these activities are usually driven by commercial factors and choices with the intention of conducting business activities in the most profitable way and to ensure that shareholders receive the maximum value. The proposed measure is likely to apply in the examples mentioned above due to the broad scope of how the funds are being used. The Tax Institute is of the view that the proposed measure should be amended to ensure that the use of funds is limited in scope and sufficiently related to the policy intent.

Retrospectivity

The measure is proposed to retrospectively apply to distributions made on or after 12pm Australian Capital Territory time on 19 December 2016. However, there remains significant uncertainty as to the broad scope of the proposed measure and the extent to which certain transactions may be affected. The MYEFO announcement and TA 2015/2 did not contain sufficient detail to accurately advise the taxpayers that may be subject to the relevant new measure, nor how these taxpayers would identify the transactions that the measure would apply to, other than the two examples provided.

Further, we note that the MYEFO announcement was simply that; an announcement. It does not have the force of law and could not be enforced by the ATO, nor relied on by taxpayers. As a general principle, prospective amendments should generally be preferred over retrospective changes. Prospective changes provide greater certainty and allow taxpayers to organise their tax affairs with a better understanding of their obligations. Announcements such as the MYEFO announcement are not law and have not gone through the review and scrutiny process to which a bill is subject before it is given the force of law.

We consider that the retrospective nature of this measure, applying from six years earlier, is especially unfair to taxpayers who have complied with the law as it has been in force in this period. Many taxpayers will have undertaken transactions, made financial decisions, and used proceeds of dividends based on the legislation at the time. If the measure applies retrospectively, entities that have undertaken legitimate restructures and/or capital raisings will be required to review transactions undertaken, to determine if the provisions could be triggered, and prepare a defensible position if they consider the proposed measure should not apply.

This means that a significant number of transactions undertaken since the MYEFO announcement will have to be reviewed and may be adversely impacted by the proposed measure. This also means that shareholders, of which many may be 'mum and dad' type of investors, may be unfairly impacted by this measure if they are denied franking credit benefits due to the actions of the company (or even an unrelated company). We note that if a distribution is deemed to be unfrankable, the company's franking account would be understated. The company would be able to reverse out the franking debit put to the franking account when they made the franked distribution. In this case the company may in fact benefit from the reversal of the franking credit at the expense of the shareholders. Further, we consider that it would be impractical for the ATO to enforce this by amending the returns of the shareholders.

The explanatory materials do not state if any penalty or interest concessions will be made where the provisions have been applied to retrospective distributions. In our view, it would be unfair for businesses caught within this measure and their shareholders to be penalised based on measures that were not in force at the time of the distribution.

Accordingly, The Tax Institute is strongly of the view that the measure should not apply retrospectively and that transitional arrangements should be introduced.

If Government intends for the measure to apply retrospectively, it is important to ensure that the measure is appropriately limited to apply only to the egregious cases envisaged in the MYEFO announcement. That is, where there is a clear purpose of capital raising solely to fund a distribution. If the measure were to apply retrospectively, we recommend that the Commissioner should have an option to debit the company's franking account rather than to deny shareholders imputation benefits (similar to section 177EA of the ITAA 1936 and subsection 204-30(3) of the ITAA 1997). This will result in a fairer outcome for shareholders who have relied in good faith on a company's action in the past.

Substantiation

The purpose test requires enquiry by the shareholder as to the purpose of a capital raising by the issuer of the shares and the relevant distribution. In many cases the recipient of the distribution will not be in a position to know or enquire into the purpose for issuing of equity. Accordingly, the shareholder will be left to exclude the possibility that the intention of the equity issue was to fund a distribution. We consider that the explanatory materials should clarify whether the entity issuing shares, the recipient of the distribution, or both, would bear the onus of proving the distribution is frankable and what records are sufficient to substantiate that claim. Further, the explanatory materials should also allow for a broad range of records to substantiate the purpose and outcomes where the distribution has occurred retrospectively.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.