Wilson Asset Management | OVER 20 YEARS Making a difference

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Director
Corporate Tax Policy Unit
Treasury
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SUBMISSION ON FRANKED DISTRIBUTIONS AND CAPITAL RAISING CONSULTATION

Dear Director,

On behalf of the 130,000 Wilson Asset Management investors, for whom we invest more than $5 billion, we are pleased to provide a response to the consultation on the proposed legislation relating to Franked Distributions and Capital Raising.

We believe that the draft legislation is inequitable to Australian companies and shareholders and that Treasury's initial estimate of the application of the legislation grossly understates the impact it will have on Australian shareholders and companies. In our opinion, the proposed legislation is a complete regulatory overreach.

The construct of the proposed legislation from Treasury is too broad and would interfere with the operation and efficiency of the Australian capital markets. The proposed legislation will significantly increase the cost of capital for all franked dividend paying Australian companies. It will also risk the stability of the Australian banking system by inhibiting effective capital raising during challenging economic periods, such as the start of the coronavirus pandemic, contrary to the advice and guidance of APRA.

If passed, its application would also unfairly burden Australian investors with retrospective tax debts, to be paid at a time of economic uncertainty.

As we noted in our letter to you dated 28 September 2022, the short timeframe allowed by Treasury for the consultation process only compounds this inequity. It does not provide adequate time for shareholders, superannuation funds, companies and industry bodies to have their voices heard and could result in this poorly formed legislation being unduly prejudicial. We strongly recommend that the **deadline to make a submission be extended to 24 October 2022.**

Yours sincerely,

Geoff Wilson AO
Chairman & Chief Investment Officer
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Jesse Hamilton
Chief Financial Officer

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A. Overview

The Federal Government's proposed policy for consultation will have a significant impact on Australian companies and their ability to pay fully franked dividends to their shareholders.

We **STRONGLY DISAGREE** with the proposed fundamental change to former Prime Minister Paul Keating's legislation regarding franking credits, originally introduced to eliminate double taxation of company earnings. The newly proposed policy by the Federal Government is inequitable in its current form and appears to be an attempt to unnecessarily revise the current franking system.

The proposed new legislation seeks to prevent Australian companies from paying franked dividends to shareholders in circumstances where Treasury believes the fully franked dividend, having failed Treasury's ambiguously drafted 'established practice' test, can be directly or indirectly linked to funding received through capital raising.

After a failed attempt in pursuing the recipients of franking credits during the 2019 election period, the Federal Government appears to now be targeting the source, Australian companies. These companies pay their taxes and will be denied the opportunity to reward shareholders with fully franked dividends based on a proposed legislation that is opaque, broad and at the discretion of Treasury and the Australian Tax Office (ATO).

As drafted, the proposed legislation would appear to inadvertently impact tens of thousands of situations of legitimate company operations and could accordingly delay or discourage the normal processes of capital raising, investment and economic growth in Australia. It could also interfere with the operation and the efficiency of the Australian capital markets and the structural integrity of our banking system.

The application of the proposed legislation to deny the ability for Australian companies to pay franked distributions (dividends) to their shareholders when directly or indirectly funded by capital raising will lead to the demise of the franking system. The 'established practice' test, as drafted, provides Treasury with the optionality to capture legitimate franked distributions paid to shareholders. It will stop Australian companies that issue new shares under a Dividend Reinvestment Plan (DRP) or undertake a DRP underwritten capital raising (from time to time), from paying franked dividends to their shareholders. It will also significantly increase the cost of capital for all franked dividend paying Australian companies and risk the stability of the Australian banking system by inhibiting effective capital management during challenging economic periods as was the case during the early stages of the coronavirus pandemic.

The legislation does not sufficiently distinguish between acceptable activities and the tax avoidance situations it intends to address. The legislation is ambiguous at best and appears to be designed to confuse and provide uncertainty, whilst Treasury retains discretion regarding any enforcement approach, which they may take both retrospectively and prospectively.

We note the retrospective application to 19 December 2016 would unfairly prejudice franked dividends paid out to shareholders of Australian companies during this time and leave them with unexpected tax bills for dividends they have already received, to be paid at a time of economic uncertainty. This legislation was initially drafted by the previous Liberal Government which we also disagreed with.

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B. Proposed legislation has unintended consequences

We recognise the intent of the legislation proposed by the Federal Government to prevent situations of intended tax avoidance and manipulation of the franking system by Australian companies.

However, the proposed legislation as drafted would appear to inadvertently impact situations of legitimate company operations and could accordingly delay or discourage the normal processes of capital raising, investment and economic growth in Australia and interfere with the operation and the efficiency of the Australian capital markets and the structural integrity of our banking system.

The legislation does not sufficiently distinguish between acceptable activities and the mischief it properly seeks to address. The legislation drafting is broad and opaque, providing material uncertainty to Australian companies and their shareholders, both on its application retrospectively and going forward.

In our assessment under the proposed draft legislation, it would appear Treasury believes that all capital raising activities, in any proximity to the payment of a fully franked dividend, can be captured under the ambiguous and broad language utilised under the 'established practice' test. This means the franked dividend paid could be linked directly or indirectly by Treasury to the raising of capital, with the associated franked credits paid out being denied to a company's underlying shareholders.

Treasury provides no time frames, guidance or examples of legitimate company operations which are acceptable under the proposed legislation. Instead, the legislation is drafted so broadly it creates material uncertainty and could unfairly prejudice Australian companies and their shareholders through the targeting of the payment of legitimate franked dividends.

Irrespective of the various situations of legitimate capital management, capital raising and franked dividend payments by Australian companies, it is a well-established practice for companies to conduct DRPs and DRP underwritten capital raisings at times of dividend payments for working capital management, to promote further economic growth and provide investment opportunities to shareholders. Under the drafting of the proposed legislation, it would appear that a simple DRP for existing shareholders and a DRP underwritten capital raising would be caught in circumstances where, in Treasury's view, the 'established practice' test is not met. The wording provided by Treasury under the 'established practice' test is so broad and ambiguous that if they chose to do so, they would retain powers under the legislation to deny the franking credits distributed to a company's shareholders on a legitimate franked dividend payment.

A fundamental change to this common practice in the Australian financial markets could have severe impacts to our most established and important companies, our authorised deposit-taking institutions and would be contrary to the Australian Prudential Regulation Authority's (APRA) guidance which was provided in our most recent economic and financial market stress, the coronavirus pandemic. The proposed draft legislation would put the structural integrity of the entire banking system and financial markets under duress.

In April 2020, APRA provided guidance on capital management to all authorised deposit-taking institutions, primarily impacting Australia's big four banks and major deposit-taking institutions. This guidance included an expectation that Boards would seriously consider deferring decisions on dividends given the uncertainty in the economic outlook at the time due to the coronavirus pandemic and **would offset any dividends to the extent possible through other capital management initiatives**, including DRPs and other capital raising initiatives to partially offset the diminution in capital from franked dividend distributions to shareholders.

As the banking industry moved beyond the initial phase of response, APRA provided updated guidance on capital management to the industry. The guidance was aimed at assisting longer-term capital management planning and to ensure the banks remained able to fulfil their role in supporting Australia's economic recovery. A key part of this guidance was the caution and advice it provided to the banks in relation to its dividends due to the ongoing uncertainty and heightened economic risk. The guidance from APRA was in relation to banks retaining at least half of their earnings and **recommended they "actively use dividend reinvestment plans (DRPs) and/or other capital management initiatives" to offset the reduction in their capital base** and balance sheets from making franked dividend payments to their shareholders.

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The application of the proposed legislation by Treasury will have far reaching impacts on the entire capital market in Australia and will risk the stability of the Australian banking system by inhibiting effective capital management during challenging economic periods as we witnessed during the Global Financial Crisis (GFC) and the coronavirus pandemic, contrary to the advice and guidance of APRA.

The demise of the franking system, which would eventuate due to the application of the draft legislation in its current form, will significantly increase the cost of capital for all franked dividend paying Australian companies and drive Australian investors abroad or force them to invest in other asset classes outside of traditional equity markets.

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C. Commercial capital management

In the running of either operating businesses or investment entities, it is normal and practical, from a working capital perspective, to generate a profit and invest the resulting cash flows productively (by purchasing further assets or applying the funds into the ongoing operations). Companies, their management and board of directors, are expected to productively utilise shareholder capital at all times and not merely retain excess cash until such time as it is distributed to shareholders by way of franked dividends.

In certain examples, the reinvestment of profits may be well outside the control of the company and its management. For example, a dividend paid by way of an in-specie distribution of an asset in lieu of cash, or a demerger that includes a deemed dividend component that is paid to the company.

Once a company generates a profit and has reinvested it to best make use of shareholder funds, it then can only create liquidity in order to pay a franked dividend in one of a few ways:

I. Obtain external debt – which may neither be possible, viable, sensible nor desirable and involves certain degrees of risk for the underlying shareholders and the company;

II. Dispose of its assets or other investments held - which incurs transaction costs or may simply not be viable if the investment is illiquid; or

III. Capital raising from shareholders.

In circumstances where a company raises capital from its investors, it:

- Accepts cash inflows from those investors wishing to increase their investment in the company (giving them increased exposure to the assets of company including those it recently acquired);
- Allows cash to be distributed as a dividend of the profits generated (which have been legitimately earned by the company and on which tax has been paid for franking credits to be distributable) to all shareholders; and
- Protects the company from the unnecessary, costly and undesirable actions of having to sell some or all of its assets or obtain external debt.

The examples provided above, as part of routine company working capital management, have nothing whatsoever to do with tax avoidance and the manipulation of the franking system as Treasury and the proposed draft legislation is suggesting. Any company that has legitimately generated and earned profits, and has paid tax on those profits, is entitled to distribute those profits and the associated franking credits to their shareholders.

The company's actions are merely those of generating and paying tax on profits, re-investing those profits, raising capital to take on the funding of those investments, and by so doing freeing up cash from its legitimately earned profits so it can pay out as a dividend to shareholders. This is not tax avoidance or the manipulation of the franking system and, in our opinion, the proposed legislation is a complete regulatory overreach.

A core element of the proposed legislation is to disallow the franking of dividends if they directly or indirectly have the effect or purpose of funding a franked dividend payment to a company's shareholders (if they also fail the broad 'established practice' test).

With the example given above, the raising of capital would most certainly have the purpose and effect of indirectly funding the franked dividend distribution, and accordingly the franking of dividends would be disallowed where the dividend also failed the established practice test. With this example, the funding of distributions out of capital is a matter solely of prudent cash flow and working capital management. It is not tax avoidance in its own right and should not de-legitimise franked dividends paid to shareholders.

Accordingly, we respectfully suggest that a company's cash flow management should not be the conceptual target of the proposed legislation and it is not Treasury's role, nor does it have the relevant expertise, to opine on how an Australian company manages its working capital on behalf of its shareholders.

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The concept of whether a company has generated profits out of which it may pay a franked dividend is a separate matter in which there is existing ATO guidance and tax determinations on. The ATO has historically published a Taxation Ruling (TR) regarding the payment of franked dividends and the requirement of a company to have a profit in order to pay franked dividends to its shareholders (TR 2012/5 Income tax: section 254T of the Corporations Act 2001 and the assessment and franking of dividends paid from 28 June 2010).

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D. 'Established Practice' Test

The 'established practice' test appears to capture dividends more broadly than its intended drafting. As drafted, it will impact any special dividend, any dividend where the amount is substantially different from prior periods and any change in timing from past dividend payments, all of which may be due to legitimate and fair company operations and not due to tax avoidance as Treasury is trying to make out through its proposed legislation draft.

The draft legislation put forward seeks to overcome the fact that the 'effect' and 'purpose' tests inadvertently catch tens of thousands of legitimate situations by exempting franked dividends paid that are part of the normal 'established practice' of the company, so long as the established practice of the franking dividend payments isn't to fund said dividends out of capital raisings of the company.

A company that pays regular franked dividends and raises capital occasionally could hope this constitutes an 'established practice' and they would be allowed to pay franked dividends. Unfortunately, the wording and scope of the draft legislation put forward is so broad this "hope" is not sufficient to properly conduct operations and capital management and will put stress on Australian companies and investors. More importantly it will put stress on the operation and efficiency of the capital markets broadly, including the structural integrity of the banking system.

However, there are still many legitimate situations that will not satisfy the 'established practice' requirement that we wish to highlight. These include, but are not limited to:

I. A company that both routinely reinvests its profits and raises capital. While this represents nothing more than prudent working capital management and with no intent to manipulate the tax system, this would appear to be caught by Clause 1.23 in the Explanatory Memorandum of the draft legislation put forward which suggests that a past practice of funding distributions from capital raisings isn't acceptable;

II. DRPs or DRP Underwriting capital raising events whereby companies enable shareholders to reinvest franked or unfranked dividends paid to them and receive newly issued shares in the company or circumstances where companies will conduct a placement under the Australian Securities Exchange (ASX) Listing Rules to raise new capital at the time of a dividend payment as a way for management and boards of directors to actively manage their working capital;

III. Growth companies that have high reinvestment needs and which may only pay dividends irregularly and would therefore not generate an 'established practice' of paying dividends;

IV. A newly established company that has no 'established practice' of paying a dividend and is in its early stages, will be reinvesting profits generated to some extent in order to fund future growth;

V. Companies with a small number of assets or investments whose income is generated irregularly or companies operating in volatile industries and who only pay dividends on an irregular basis;

VI. Companies receiving a large in specie distribution in lieu of cash where their resulting income is materially higher than normal (e.g. from demerger activities); and

VII. Companies investing in businesses that go through large capital restructures and which generate irregular profits.

The list of legitimate situations that would not constitute established practice is large and goes well beyond the short list of examples provided above.

Accordingly, it would appear that an 'established practice' test under the proposed legislation put forward will not act as a sufficient 'filter' for Treasury to distinguish between tax avoidance and the legitimate and normal operations of many businesses operating in Australia, consistent with their own 'established practice' since their inception.

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E. Retrospective application

The issue of whether a retrospective application of laws is appropriate, as Treasury intends with the proposed draft legislation, is a secondary issue which depends on the nature and merit of the core legislation itself.

Accordingly, with the core legislation drafting to be so broad and containing ambiguous language, as well as appearing to inadvertently target many legitimate company operations, it would not be appropriate for Treasury to apply the proposed legislation retrospectively to 19 December 2016.

However, if the core legislation were to accurately target clear situations that were knowingly designed for historical tax avoidance, a case could be made for retrospective application of that component of the legislation.

As drafted, the proposed legislation targets matters of subjectivity, policy, planning and usual business operations, and as such it would be highly inappropriate to apply the law retrospectively.

In its current form, the application of the proposed legislation would unfairly burden Australian investors with retrospective tax debts, to be paid at a time of economic uncertainty.

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F. Conclusion

We appreciate that there may be mischievous situations involving tax avoidance and franked dividend distributions that Treasury understandably seeks to deal with through an appropriate piece of tax avoidance legislation.

However, rather than limiting the legislation to a few instances of mischief and providing specific drafting and language in the legislation to be utilised by Treasury with a clear and honest application, in its current form the legislation draft would appear to inadvertently catch normal and legitimate situations of company operations.

The inadequate construct of the proposed legislation from Treasury is too broad and would interfere with the operation and the efficiency of the Australian capital markets and the structural integrity of our banking system, contrary to the advice and guidance or APRA.

The 'established practice' and 'effect' and 'purpose' tests do not appear to target a few instances of mischief that Treasury has communicated under the conceptual purpose of the legislation and the language in the draft is so broad it can be manipulated and applied by Treasury to suit any purpose or agenda they are wishing to follow.

Accordingly, we question whether this is a suitable construct with which to design this legislation in its current form and we are concerned that the proposed legislation is another attempt by the Federal Government to cause the demise of the franking system and ultimately disenfranchise Australian investors. In our opinion, the proposed legislation is a complete regulatory overreach.

The problem lies at the conceptual heart and drafting of this proposed legislation. The funding of franked distributions out of capital, if and when it occurs, is a matter solely of cash flow management for an Australian company to manage and it is not the position of Treasury to advise companies on how they should manage their working capital.

It is not tax avoidance in its own right and it should not delegitimise franked dividends paid out to shareholders as a result. The payment of dividends where no profit has been generated by a company is a separate matter entirely and one that existing taxation rulings and determinations already address.