TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO. #) BILL 2014: PREVENTING DIVIDEND WASHING

EXPLANATORY MATERIALS

Chapter 1
Preventing dividend washing

Outline of chapter

1.1 Schedule # to this Bill will amend the *Income Tax Assessment Act 1997* (ITAA 1997) to introduce an integrity rule to limit the ability of taxpayers to obtain a tax benefit from 'dividend washing'.

1.2 Broadly, dividend washing (or 'distribution washing') is a type of scheme by which a taxpayer can obtain multiple franking credits in respect of a single economic interest by selling an interest after an entitlement to a franked distribution has accrued and then immediately purchasing an equivalent interest with a further entitlement to a corresponding franked distribution.

Context of amendments

The imputation system

1.3 Under Australian income tax law, corporate tax entities (companies, corporate limited partnerships and certain trusts – see section 960-115 of the ITAA 1997) are subject to income tax on their taxable income. Members of the corporate tax entity (i.e., shareholders) are also generally subject to income tax on the economic income of the corporation when it is distributed to them.

1.4 The imputation system set out in Part 3-6 of the ITAA 1997 provides members with relief from tax where they receive distributions that have been subject to tax at the corporate level. Under this system, corporate tax entities can pass on a credit for the tax they pay (a franking credit), when they provide a frankable distribution to their members (see Division 202 of the ITAA 1997).

The consequences of franking

1.5 Members that receive franked distributions are generally entitled to a refundable tax offset equal to the amount of the franking credit allocated to the distribution. They must also include an equivalent amount in their assessable income for the same income year (section 207-20 of the

ITAA 1997). This puts the members of the corporation in the same position as if they had earned the corporate income themselves, and that distributed income was subject to withholding prior to being paid to the member. This means that the corporate income distributed to a member is effectively taxed only at the member's marginal tax rate.

1.6 As the tax offset provided is generally refundable, where the tax paid by the corporate tax entity exceeds that payable by the taxpayer this can result in a refund (subject to the other tax liabilities of the taxpayer).

1.7 Special rules apply to particular types of members.

1.8 Where a member is a trust or partnership (and so does not generally pay tax that can be offset), the member must still include the amount of the credit in their income, but does not receive an offset. Instead, the tax offset goes instead to the underlying interest holders, that is the partners or beneficiaries who pay the tax on the income of these flow-through vehicles (Subdivision 207-B of the ITAA 1997).

1.9 Where a member is not an Australia resident, the member is not entitled to a tax offset or required to include the amount of the distribution in their assessable income. Instead, a franked distribution is exempt from dividend withholding tax (Subdivision 207-D of the ITAA 1997). That is, the foreign resident pays no further tax with the corporate tax being the only tax paid on that income.

Imputation and franking credit trading

1.10 Due to the differing treatment of franking credits received by different entities and differing tax rates applied to entities, not all members benefit equally from a distribution being franked. Generally, members who have either a low tax rate or little income and can access a refundable tax offset benefit most from imputation. These entities, including for example, individuals on low marginal tax rates, charities and complying superannuation funds, may be able to fully offset the tax payable on their income and obtain a payment from the Commissioner of Taxation. The benefits to other types of entities are often focussed on directly preventing double taxation and are therefore more limited or situational.

1.11 As not all shareholders benefit equally from franking credits, there is an incentive to transfer, provide or sell franking credits to those shareholders who will receive a greater benefit.

1.12 Franking credit trading is contrary to the underlying policy of the imputation system, and a number of integrity rules exist to prevent practices that give this result (see Subdivision 207-F of the ITAA 1997).

1.13 These rules include:

- the holding period rule, which broadly requires that an interest must be held at risk for a period (generally, 45 days) before the interest holder may benefit from franking credits;
- the last-in first-out rule, which provides that the disposal of an interest will be deemed to be the disposal of the most recently acquired interest (preventing taxpayers from using staggered acquisitions and disposals to avoid the consequences of the holding period rule); and
- prohibitions on dividend streaming, dividend stripping (under Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936)) and franking credit trading.

1.14 In general, where these rules apply, taxpayers will not receive a tax offset (or be required to include an amount of the associated franking credit in their assessable income) despite receiving a franked distribution.

Dividend washing

1.15 Generally, the entitlement of all interest holders to receive a distribution is fixed at the same point in time. While interests can be traded after this point (referred to as trading ex-dividend), the new interest holder will not be entitled to receive the distribution.

1.16 However, for some shares, a special market for trading in shares with the attached right to the dividend (this is referred to as trading cum-dividend) will operate for a period between the date on which the entitlement to the dividend is fixed for most interest holders (the ex-dividend date) and the final date of record for dividend entitlements.

1.17 It is also possible to trade shares off market on a cum-dividend basis during this period.

1.18 Such special markets were established to address problems that could otherwise arise for entities that issue call options. As there is a delay between when the option is exercised and when the issuer becomes aware of their obligation to provide a share, cases could arise where entities are obliged to provide shares cum-dividend but cannot obtain such a share on market as the ex-dividend date has passed.

1.19 However, these special markets also provide an opportunity for entities that place a higher value on franking credits to obtain multiple franking credit entitlements in respect of one economic interest.

1.20 Such entities can sell a membership interest on the normal market after becoming entitled to the distribution, and then purchase a substantially identical membership interest on the cum-dividend market. This entitles the entity to a second amount of franking credits in place of someone who places a lesser value on those credits. The acquisition and disposal prices paid and received can be adjusted to share the benefits of the arrangements – that is, a taxpayer who does not benefit as much from franking credits can sell their interest at a price that allows them to obtain some of the benefits of the credit passed on to the other taxpayer.

1.21 An entity engaging in distribution washing is able to satisfy the holding period rule in respect of both interests without breaching the last-in first-out rule. They hold the original interest for at least 45 days prior to the ex-dividend date and the new interest for at least 45 days after its acquisition, without ever holding the two interests at the same time.

1.22 In some cases, distribution washing arrangements will be a scheme subject to the general anti-avoidance rules under Part IVA of the ITAA 1936.

Summary of new law

1.23 Part 1 of Schedule # amends the ITAA 1997 to provide that franked distributions which a taxpayer receives due to distribution washing will not entitle the taxpayer to a tax offset or require a taxpayer to include the amount of the franking credit in their assessable income.

1.24 A distribution will be considered to be one received as a result of distribution washing, where the taxpayer has also received a corresponding distribution in respect of a substantially identical interest that the taxpayer sold before acquiring the current interest.

1.25 These amendments apply from 1 July 2013.

Comparison of key features of new law and current law

New law	*Current law*
Taxpayers that obtain additional franking credits as a result of distribution washing will be denied any benefit from these additional credits. An exception applies for individuals	There is no general rule eliminating the benefits of further franking credits a taxpayer obtains as a result of distribution washing. In some cases, Part IVA of the ITAA 1936 may apply to allow the

New law	Current law
whose annual franking credit entitlement is below $5,000.	Commissioner of Taxation to make a determination to deny benefits.

Detailed explanation of new law

1.26 Part 1 of Schedule # amends the ITAA 1997 to provide that distributions to which the distribution washing rules apply:

- do not receive a tax offset; and
- are not required to include an amount equal to the franking credit in their assessable income.

[Schedule #, items 1 and 2, paragraphs 207-145(1)(da) and 207-150(1)(ea)]

1.27 The distribution washing rules will apply to a franked distribution in respect of a membership interest (the washed interest) where two requirements have been met.

1.28 First, the washed interest must have been acquired after the member or a connected entity of the member, disposed of a substantially identical membership interest. ***[Schedule #, item 3, paragraph 207-157 (1)(a)]***

1.29 Secondly, a corresponding distribution must have been made to the member or a connected entity in respect of the substantially identical interest. ***[Schedule #, item 3, paragraph 207-157 (1)(b)]***

Substantially identical interest

1.30 Central to both of these requirements is the existence of a substantially identical interest.

1.31 The concept of substantially identical is drawn from the existing law for the holding period rules. The concept is intentionally flexible to accommodate the wide variety of financial instruments that currently exist and as well as new instruments that may be created in future. Without constraining the concept, the amendments identify a number of circumstances in which interests are substantially identical for the purpose of the provisions (drawn from similar provisions relating to the last-in, first-out method under the holding period rules; see the former section 160APHF of the ITAA 1936). ***[Schedule #, item 3, subsection 207-157(2)]***

1.32 The most important of these is that an interest will be substantially identical where it is fungible with, or economically equivalent to, the washed interest. In this context, it makes clear that the

identity that is being examined is the economic substance of the interest not the property rights. The item ensures that interests will be substantially identical where it is reasonable to expect that the interests will provide equivalent economic benefits.

1.33 It does not necessarily matter that the nature of the interest may vary and it is not pertinent if one interest is legal and the other equitable, or if one interest is an interest in another entity that nonetheless provides equivalent benefits indirectly, because, for example, all it holds is interests in a particular corporate tax entity.

1.34 What can matter in determining if an interest is substantially identical is the number or extent of the interests held at each time. Where an entity sells interests ex-dividend and purchases a different number of interests cum-dividend, it is possible that only some of an entity's interests may be substantially identical to the washed interest, as economic equivalency must be considered in the full context of the former and current interests.

1.35 For example, a taxpayer may sell one ordinary share in an entity ex-dividend then later purchases 100 ordinary shares in the same entity cum-dividend. The prior interest here is substantially identical to the washed interest represented by one of the shares purchased cum-dividend. It is not substantially identical to the whole 100 shares. In this case, the taxpayer would not be entitled to the benefits of franking credits in respect of the portion of the distribution relating to one share that is the substantial identical interest, but may still be entitled to franking credits in respect of the 99 additional shares acquired.

Example 1.1

Elizabeth (an Australian resident taxpayer) holds 100 ordinary shares in OT Ltd. On 14 April 2015, OT Ltd declares it will pay a fully franked dividend of 10 cents to all holders of its ordinary shares.

Elizabeth disposes of all 100 shares shortly after the shares commence trading ex-dividend. She retains the right to receive a fully franked dividend in respect of the 100 shares she has sold.

Immediately after disposing of the shares, Elizabeth purchases 200 ordinary shares in OT Ltd in a special cum-dividend market. Elizabeth is now also entitled to a fully franked dividend in respect of the 200 newly acquired shares.

As Elizabeth has disposed of her original shares then acquired new shares, to the extent that the new shares are substantially identical interests, and the distribution in respect of the original shares is a

corresponding distribution, she will not be entitled to the benefits of the franking credits she has received in respect of the new shares.

One hundred of the new shares are economically equivalent to the interests represented by the 100 original shares and the dividends paid in respect of these two groups of interests clearly correspond.

However, the remaining 100 of the new shares Elizabeth has acquired are not substantially identical, given they are interests going beyond the total of the prior interests held by Elizabeth.

As a result, Elizabeth is entitled to the benefit of the franking credits she receives in respect of the 100 shares she disposed of and 100 of the new shares she has purchased (assuming no other integrity rules have been engaged). She is not entitled to any the benefits of the franking credits attached to the dividends she receives for the remaining 100 new shares.

1.36 However, what matters in these cases is the economic equivalency of the interests, rather than the numbers. In cases where there are different classes of shares in an entity or where interests are held indirectly, interests may well be economically equivalent despite taking different forms or involving different numbers of interests.

Example 1.2

Sophie (an Australian resident taxpayer) holds 10 Class A shares in NAFR Ltd. On 20 March 2015, NAFR Ltd declares a $5 fully franked dividend on all of its Class A shares and a $1 fully franked dividend on all of its Class B shares (with the ratio between the dividends being a matter of established practice).

Shortly after her shares commence trading ex-dividend, Sophie sells all 10 shares, retaining the $50 fully franked dividend entitlement. Sophie then purchases 65 Class B shares in NAFR Ltd in a special cum-dividend market. She becomes entitled to fully franked dividends in respect of those shares totalling $65.

Sophie has disposed of shares she held and acquired new shares and she is entitled to corresponding dividends in respect of each set of interests. To the extent the shares are substantially identical, Sophie is not entitled to the benefits of franking credits attached to the dividend in respect of the Class B shares.

The Class B shares are not interchangeable with the Class A shares. However, in the circumstances they are in part economically equivalent – 10 Class B shares will provide the same immediate returns and similar expected returns as one Class A share.

> As a result, 50 of the Class B shares are substantially identical to the 10 Class A shares Sophie sold. Sophie is entitled to the benefit of the franking credits she receives in respect of her original 10 Class A shares and 15 of her new Class B shares (assuming no other integrity rules have been engaged). She is not entitled to receive the benefit of the franking credits she receives in respect of the remaining 50 of the Class B shares she has acquired.

1.37 The amendments also specify that a number of other types of interest are substantially identical, without limiting the ordinary meaning of the term. These other items deal with a number of more specific interests, including interests in the same or similar classes of interest and those in other classes that are exchangeable at a fixed rate. The more specific provisions are intended to provide clarity in most of the common cases where the rule against distribution washing may apply.

Disposal

1.38 The rules also require that the substantially identical interest must have been disposed of before the washed interest was obtained. The application of this requirement will generally be a simple matter of fact.

1.39 The purpose of this requirement is to avoid overlap between this integrity rule and the existing ‘last in, first out’ rule contained within the holding period rules. Where the two interests are held concurrently, the combined effect of the holding period rules and the last-in first-out rule already prevents the entity from benefiting from multiple franking credit entitlements.

Connected entity and intention

1.40 This integrity rule is intended to address any case in which taxpayers may obtain multiple franking credits in respect of a single economic interest.

1.41 To give effect to this, none of the requirements for distribution washing relate to the intention or state of mind of the taxpayer.

1.42 While deliberate distribution washing is particularly problematic, even inadvertent distribution washing results in taxpayers receiving inappropriate benefits. Additionally, requiring proof of intention would also increase the compliance burden on taxpayers and the ATO and was raised as a concern in consultation.

1.43 As another mechanism for preventing this double benefit, the distribution washing rules look at the actions of connected entities as well as the member.

1.44 As these entities are connected, they are holding a single economic interest as a single economic group and therefore should only collectively be entitled to a single benefit from the imputation system as a result of a single distribution event.

1.45 Given this, where a connected entity disposes of a substantial identical interest, the distribution washing rules can apply to deny the benefit of franking credits on the distribution from the washed interest.

1.46 Taking into account the actions of connected entities prevents related taxpayers from colluding with one-another to obtain the tax benefit indirectly and avoid the restriction.

1.47 This is particularly important where the member receiving the distribution is a trust or partnership. In this case, it is the ultimate beneficiary of the distribution, the beneficiary or partner, rather than the trust or partnership that receives the franking credit. Application of the connected entity rules means that entity to which a franked distribution flows indirectly are treated in the same way as the entity to which a franked distribution is made.

1.48 Connected entity is an existing defined term in the ITAA 1997. An entity will be a connected entity where it is either an associate or (if the taxpayer is part of a wholly-owned group) a member of the same wholly-owned group.

Example 1.3

Giraffe Ltd is a wholly-owned subsidiary of Zoo Ltd.

Zoo Ltd disposes of 1,000 ordinary shares in Hay Co immediately after they go ex-dividend, retaining the fully franked dividend entitlement. Shortly after this disposal, Giraffe Ltd purchases 1,000 ordinary shares in Hay Co in a special cum-dividend market, obtaining an equivalent entitlement to fully franked dividends.

As Giraffe Ltd is an associate of Zoo Ltd, the distribution washing rules will apply to this transaction and deny Giraffe Ltd the benefit of the franking credits it receives in respect of the 1,000 shares it has acquired.

Example 1.4

Rose and Tom are a married couple. Rose, but not Tom, is a beneficiary of Flower Trust. The trustee of Flower Trust is Bloom Ltd.

Bloom Ltd, acting in its capacity as trustee of Flower trust, disposes of 300 shares in Sunshine Co shortly after the shares go ex-dividend. It remains entitled to the fully franked dividend on the shares.

Both Rose and Tom are associates of Bloom Ltd in its capacity as trustee, Rose as a beneficiary of the trust, and Tom as an associate of Rose. If either Rose or Tom purchase a substantially identical interest (which could an interest of the same type in Sunshine Co, but could also be some other type of economically equivalent interest) and receive a corresponding dividend, they will be subject to the distribution washing rules.

Example 1.5

RC Ltd and SC Ltd are two separate wholly-owned subsidiaries of KAS Investments Ltd. While they share an owner and are both involved in investment activities, the two companies are otherwise unconnected.

RC Ltd disposes of an interest in WLC Co shortly after the interest goes ex-dividend. It remains entitled to the fully franked dividend on the shares.

RC Ltd and SC Ltd are associated as they are both wholly-owned by KAS Investments Ltd. Given this, if SC Ltd purchases a substantially identical interest and receives a corresponding distribution, it will not be entitled to the benefit of the franking credit in respect of that distribution.

1.49 Consistent with the general rule around intention, there is no requirement that the member and the connected entity be engaged in a scheme, or even be aware of each other's actions. Given the closeness of the relationship between connected entities, it would be impossible for the Commissioner of Taxation to administer a rule that requires evidence of whether the entity's had or had not intentionally worked together to access a tax benefit from distribution washing.

1.50 In some cases, for example when investing through trust structure there may be several degrees of separation between the ultimate beneficiary and the entity that has engaged in distribution washing. The loss of the benefit of the franking credit would need to be reflected in the information provided by the trustee at each stage, in the same way as presently applies for interests where the benefit of franking credit is denied due to the application of the holding period rule.

1.51 While intention is not a relevant factor in applying the distribution washing rules, the ability of individual taxpayers to engage in distribution washing is limited because of the complex nature of the special market and limitations on who can participate directly in it. A

special exception is available for individual taxpayers entitled to less than $5,000 worth of franking credits (see paragraphs #.# to #.# below).

Corresponding distribution

1.52 Like substantially identical interest, the concept of corresponding distribution is also a flexible concept that is drawn from the holding period rules.

1.53 For distributions to correspond, it is not enough that they are of the same amount or from the same entity.

1.54 Correspondence requires that that the distributions have ultimately arisen from the same ultimate source, or closely connected sources.

1.55 This will most obviously be satisfied in cases where a company declares a dividend to classes of membership interest including both the washed interest and the substantially identical interest.

1.56 It will also be satisfied where both dividends arise from the company declaring various dividends in respect of different types of membership interest on a common basis, in connected processes or in respect of profits that have arisen over the same period.

1.57 In some cases a dividend may be a corresponding dividend even where it is not paid by the same entity, provided the dividends ultimately arise from the same act. For example, a dividend from one company that was paid for the purposes of passing on a dividend from another company would be a corresponding distribution in respect of other dividends paid out by the other company in the same distribution process.

Example 1.6

Tuba Ltd has two classes of shares, ordinary shares and preference shares.

Its preference shareholders are entitled to receive an annual dividend of a fixed amount, subject to Tuba Ltd having profits available to distribute. Its ordinary shareholders have no fixed entitlement to dividends.

On 10 August 2015, Tuba Ltd declares a dividend in respect of its preference shares. On 11 August 2015, it further declares a dividend in respect of its ordinary shares.

Dividends paid in respect of ordinary shares will be corresponding dividends in relation to the dividends paid on preference shares and vice versa.

While the dividends are not necessarily of the same amounts and the obligations around payment differ, they both come from the same entity and are tied to the profitability of the company over the same period.

Example 1.7

Paul holds shares in Holding Ltd. Holding Ltd is a collective investment vehicle which has no assets other than shares in Big Ltd.

On 30 September 2015, Big Ltd declares a fully franked dividend to all shareholders, including Holding Ltd.

On 18 November 2015, Holding Ltd declares a fully franked dividend to its shareholders.

The dividend paid by Big Ltd is a corresponding dividend in relation to the dividend paid by Holding Ltd. The dividend is not paid by the same company or declared at the same time. However, both originate from the same ultimate source.

Example 1.8

Bentwood Ltd pays its annual fully franked dividend to its ordinary shareholders on 7 May 2016.

On 17 June 2016, Bentwood Ltd becomes entitled to significant amounts of money as a result of its success in contractual litigation.

It decides to return these amounts to its shareholders by declaring a special dividend.

The annual dividend is not a corresponding dividend in relation to the special dividend. While both are paid by the same entity in close succession, they arise from different sources and as part of separate processes.

Small holdings exception

1.58 Similar to the holding period rules, the amendments provide for an exception to the restrictions on distribution washing for individuals who receive less than $5,000 in franking credits in a year. ***[Schedule #, item 3, subsections 207-157(3) and (4)]***

1.59 Such individuals will generally not be in a position to deliberately engage in distribution washing in respect of those interests

they hold directly. They will generally lack the knowledge and expertise to access the special market for cum-dividend trading. In the event that they do become involved in distribution washing, the amounts involved are, by definition, small.

1.60 This exception protects small shareholders from needing to consider the application of the rule to their individual investments.

1.61 However, this exception only applies to distributions made directly to an individual. It does not apply to distributions that may flow indirectly to individuals in respect of an interest held through a trust or partnership.

1.62 As a collective investment vehicle, trusts and partnerships can be in a position to engage in distribution washing on a significant scale even where the investments held on behalf of each individual beneficiary or partner are small. As a result, the considerations supporting an exception for individuals do not apply in this case.

1.63 Despite the small holding exemption, individuals under the $5,000 threshold are still potentially subject to the general anti-avoidance rule under section 177EA of Part IVA of the ITAA 1936 if they engage in a distribution washing scheme with the dominant purpose of obtaining a tax benefit.

Application and transitional provisions

Distribution washing

1.64 The amendments to prevent distribution washing apply from 1 July 2013, the date set out in the original policy announcement of 14 May 2013. ***[Schedule #, item 4]***

1.65 This may result in the amendments having retrospective application. This retrospectivity is necessary to prevent taxpayers from taking ongoing advantage of the loophole distribution washing represents in the existing franking credit integrity rules after its existence was made publicly available by the Government's announcement.

1.66 Further, distribution washing requires highly specific activities (generally selling ex-dividend and buying cum-dividend) that will generally not have a commercial rationale without the availability of the associated tax benefits. Given this, there is relatively little uncertainty arising from taxpayers from this retrospectivity, as it is unlikely taxpayers

would be inadvertently affected by the measure or affected in a way that they would not expect from the announcement.