Preventing dividend washing

Discussion Paper
June 2013

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REQUEST FOR FEEDBACK AND COMMENTS

The Government seeks your feedback and comments on the measure outlined in this discussion paper. The information obtained through this process will inform the Government's approach to the implementation and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

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Closing date for submissions: Monday, 17 June 2013

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FOREWORD

It is important that Australia secures a fair, competitive and sustainable tax base for the future prosperity of this nation.

The Government is committed to taking action to protect the integrity of Australia's corporate tax base. As part of this, we are acting to prevent 'dividend washing' — a practice that undermines the integrity of the company tax imputation system by enabling shareholders to claim two sets of franking credits on what is effectively the same parcel of shares.

The measure will improve confidence in the imputation regime by helping ensure that franking credits only benefit the true economic owners of shares, and that franking credits are only available to shareholders in proportion to their shareholdings.

These are important and necessary reforms that will improve the integrity of, and ensure confidence in, Australia's tax system. I welcome your participation in this process.

The Hon David Bradbury MP
Assistant Treasurer

1. OVERVIEW

1. From 1 July 2013, the Government will remove a loophole that currently allows sophisticated investors to engage in a process known as 'dividend washing'. This process circumvents Australia's dividend imputation integrity rules by allowing sophisticated investors to effectively trade franking credits, allowing some shareholders to receive two sets of franking credits for effectively the same parcel of shares.

2. The purpose of this discussion paper is to:

- explain how dividend washing occurs, and how it circumvents Australia's dividend imputation integrity rules;
- canvass legislative options that the Government is currently considering to prevent dividend washing;
- provide background information on dividend washing;
- outline the process for making submissions to this discussion paper, and the key issues that submissions should address; and
- outline the process for developing and communicating a final legislative response.

2. THE PROBLEM WITH DIVIDEND WASHING

3. Australia's imputation regime is generally effective at removing double taxation through the company and personal income tax systems. However, it can result in arbitrage opportunities because some shareholders place a higher value on franking credits than others. Some of these arbitrage opportunities have been addressed through the introduction of a holding period requirement, and others through specific anti-avoidance provisions. Other arbitrage opportunities pose limited risks to tax revenue, or could not be addressed without compromising the efficient operation of capital markets.

4. In order to maintain integrity over time, the Government is required to reassess the operation of the imputation regime and related integrity provisions in light of emerging market practices. Dividend washing is an emerging practice by which sophisticated shareholders are able to circumvent the current integrity rules and trade franking credits. The practice allows sophisticated shareholders to claim two sets of franking credits in relation to what is effectively a single parcel of shares. While relatively modest amounts of revenue are being lost as a result of this conduct, significant amounts of revenue would be at risk if the practice were to become widespread.

2.1 How dividend washing occurs

5. Dividend washing allows shareholders who place a relatively low value on franking credits (such as non-residents) effectively to sell their franking credits to shareholders who place a relatively high value on franking credits (such as superannuation funds, income tax exempt not-for-profit entities, and other shareholders with low marginal tax rates) generally for non-taxable consideration (because, for example, of portfolio share profit exemptions for non-residents). The transactions may in some circumstances be on revenue account for the resident participants, meaning that deductible losses in respect of the share transactions are available to offset dividend income.

6. The process occurs in the period after a share goes ex-dividend. During this period shares are generally traded on an ex-dividend basis, which means that the right to the recently announced dividend is retained by the vendor of the shares. However, during this period Trading Participants of the Australian Securities Exchange (ASX) are also able to request the establishment of special cum-dividend markets for the two business days after a share goes ex-dividend. When shares are traded in these markets, the right to the recently announced dividend is transferred to the purchaser of the shares.

7. Dividend washing involves shareholders who place a relatively high value on franking credits selling shares on an ex-dividend basis and purchasing shares on a cum-dividend basis (in the period after a share goes ex-dividend). This enables these shareholders to receive two sets of dividends: one set is retained during the sale of ex-dividend shares; the other is obtained during the purchase of the cum-dividend shares. The problem with this situation is that the shareholders are then also able to claim the two sets of franking credits attached to the dividends, despite having only ever held, in substance, one parcel of shares at any point in time. This is outside the intent of the imputation regime as some shareholders are able to obtain a disproportionately high level of franking credits, given their shareholdings.

8. Shareholders who place a relatively low value on franking credits are often counterparties to these transactions. These shareholders purchase shares on an ex-dividend basis and sell shares on a cum-dividend basis, and therefore receive no dividends on their shares. They are compensated for forgoing their rights to the dividends through a higher price for the shares sold on a cum-dividend basis. In addition, they are able to capture some of the value of the franking credits because the market prices the shares sold on a cum-dividend basis at a slight premium. This is also outside the intent of the dividend imputation regime as it results in the value of the franking credits being transferred from shareholders who should not be able to use them to those that can.

9. Dividend washing results in sophisticated shareholders receiving two sets of franking credits for the same effective parcel of shares. Treasury costings indicate that dividend washing currently reduces Commonwealth tax revenue by around $20 million per year, and that this would likely grow in the future if no action is taken to address the problem.

Example Box 1: Dividend washing

Scenario:

A superannuation fund (with a marginal tax rate of 15 per cent) owns 10,000 shares in Company A that are priced at $100 each. These are the only shares that the superannuation fund owns, and are the fund's only source of income. The shares are held on capital account.

Company A announces a fully-franked dividend of $7 (which will include franking credits worth $3).

Step 1:

As soon as the shares go ex-dividend, the superannuation fund sells the shares for $93 each, retaining its right to the dividend and the associated franking credits. The price drop to $93 reflects the value of the dividend forgone to the purchaser.

Step 2:

The superannuation fund then purchases 10,000 shares in Company A in a special cum-dividend market, from a non-resident hedge fund for $100.75 each. The price reflects the value of the share, plus the dividend, plus a small premium for the franking credits.

Step 3:

The superannuation fund is then able to claim two sets of franking credits (one for the ex-dividend share and one for the cum-dividend share). The superannuation fund will receive franking credits worth $60,000 to offset a tax bill of $30,000 (this is calculated as the value of the grossed up dividend, multiplied by the number of dividends, multiplied by the tax rate for the superannuation fund (($7+ $3) x 20,000 x 15%). Consequently they receive refundable tax offsets of $30,000.

Outcome

The superannuation fund paid a premium of $7,500 (10,000 x $0.75) for the cum-dividend shares and obtained refundable tax offsets from these shares worth $15,000 (note, half of the $30,000 of refundable tax offsets resulted from the initial share holdings in Company A). Therefore, the value of the dividend washing arbitrage to the superannuation fund is $7,500.

The value of the dividend washing arbitrage to the non-resident hedge fund is also $7,500 (the value of the premium on the cum-dividend shares). In this case, the value of the tax benefits of the dividend washing arbitrage is shared equally between the hedge fund and the superannuation fund.

However, the dividend washing arbitrage results in a cost to revenue of $15,000. This is because, if the cum-dividend shares were not sold by the non-resident hedge fund, the hedge fund would not have been able to claim a refund for the franking credits.

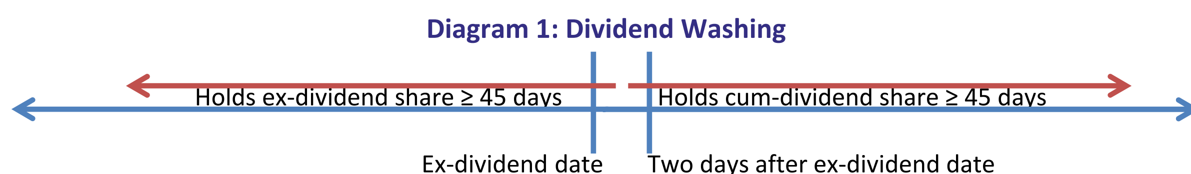
2.2 How dividend washing circumvents the imputation integrity rules

10. Australia has holding period rules to prevent shareholders from effectively trading franking credits. The rules require shareholders to have held an ordinary share at risk for 45 days (90 days for preference shares) in order to be able to claim the franking credits attached to a dividend. The rules prevent shareholders from purchasing shares just before they go ex-dividend, capturing the dividend and the attached franking credits, and then selling the shares shortly afterwards. Small shareholders that have less than $5,000 of franking credit tax offsets are exempt from the holding period rules.

11. The holding period rules also include a 'last-in first-out' (LIFO) rule. Under this rule, when a shareholder sells shares in a particular company, the shares sold are taken to be the shares that the shareholder most recently purchased in the company. This prevents shareholders who have already held some shares in a company for more than 45 days from purchasing additional shares just before they go ex-dividend, capturing the dividend and franking credit, selling the additional shares shortly afterwards, and then claiming that the shares sold were those shares that were already held for more than 45 days.

12. Dividend washing circumvents the LIFO rules by creating a short break in the ownership of shares by selling the ex-dividend shares just before purchasing the cum-dividend shares (see Diagram 1 below). The existence of the break in ownership means that the LIFO rule is never activated. As long as each set of shares is held for at least 45 days, the shareholder is able to claim two sets of franking credits.

Diagram 1: Dividend Washing



13. In addition to the holding period rules, Australia has anti-avoidance rules to prevent the abuse of the imputation system through schemes that circumvent the basic rules for the franking of dividends. The anti-avoidance rules were intended to be a 'catch-all' provision to deal with schemes not explicitly addressed by specific integrity rules in the imputation regime. As with any anti-avoidance provisions, the operation of the rules are dependent upon an examination of relevant circumstances to form a conclusion as to the purpose of a scheme. While not ruling out the application of the current general anti-avoidance rules to dividend washing schemes, more efficient ways of dealing with these arrangements may exist that would provide certainty to shareholders, and ensure that dividend washing is prevented in the future.

3. Legislative options to address dividend washing

3.1 Principles for developing a legislative response

14. The legislative response that the Government decides upon will:

- prevent shareholders from receiving two sets of franking credits for the same effective parcel of shares through dividend washing;
- ensure that there are negligible impacts on legitimate market activities; and
- result in a minimal level of uncertainty and complexity for taxpayers.

15. The Government recognises that special cum-dividend markets exist for legitimate reasons, and has no intention preventing the establishment of special cum-dividend markets or affecting legitimate market activities. Therefore, any legislative response will be targeted to preventing dividend washing in the simplest and most efficient manner possible.

16. Three potential approaches for preventing dividend washing are outlined below. While the Government is currently considering modifying the holding period rules to prevent dividend washing, it is open to considering other options that could complement or substitute this approach.

3.2 Modifying the holding period rules

17. This approach would involve modifying the holding period rules to address the break in ownership that is achieved through dividend washing. The modification would be targeted to the period between the ex-date and record date for a dividend (for more detail around ex and record dates see background information).

18. In this period, the modification to the LIFO rule would ensure that when a shareholder sells ex-dividend shares and then purchases cum-dividend shares in the same company, the purchase of the cum-dividend shares would be taken to have occurred immediately before the shares went ex-dividend. In Diagram 1 above, this would mean that the red lines representing the ex-dividend and cum-dividend shares would be taken to overlap.

19. As a result, shares sold on a cum-dividend basis would be taken to have been held for less than 45 days. The operation of the LIFO rule would deem the actual disposal of the ex-dividend shares to be a disposal of the cum-dividend shares for the purposes of the holding period rules. Accordingly, the shareholder would only be able to claim the franking credits relating to the shares sold on an ex dividend basis (assuming that these shares were held for more than 45 days), and would only be able to claim one set of franking credits.

20. The holding period rules were written in former Division 1A of Part IIIAA of the *Income Tax Assessment Act 1936 (ITAA 1936)*. These rules continue to apply by reason of s.207-145(1)(a) and s.207-150(1)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997). However, the rules more broadly are currently being transferred to the *ITAA 1997* and as a result any amendments to the rules could only be legislated once the transfer of these rules is completed. This will take place after the Government's policy to prevent dividend washing comes into effect on 1 July 2013.

21. It would therefore be important to ensure that if the Government decides to modify the holding period rules there is a clear understanding of how the modifications would apply in practice. Submissions should outline if any uncertainty would result from the Government communicating its policy using the description outlined above.

22. A key benefit of modifying the holding period rules is that the holding period rules are self-executing, and would therefore provide taxpayers with a high level of certainty. This is in contrast to the potential amendments to the anti-avoidance provisions below, which would require a higher level of judgement and result in a higher level of uncertainty.

23. One key question regarding the modifications to the holding period rules concerns whether the period targeted is time-based or concept-based. That is, should the modifications target the 48-hour period after a share goes ex-dividend (the timeframe in which shares are able to be traded on a cum-dividend basis once they have gone ex-dividend) or cover the period between the ex-dividend date and the record date. The latter option clearly has more flexibility to adapt to changing market practices, however, submissions should outline if this approach could create unintended consequences.

3.3 Adding a criterion to the anti-avoidance provisions

24. This approach would involve amending the anti-avoidance provisions for the imputation system by allowing the Commissioner to take into account the timing of trades when determining whether a franking credit should be claimable. Specifically, this approach would involve adding a criterion to section 177EA(17) of Part IVA of the *ITAA 1936* to highlight that the timing of trades is a relevant factor when determining if a scheme was designed with a tax avoidance purpose.

25. This approach would have the benefit of being adaptable to any future schemes designed to allow dividend washing that currently don't exist. However, as a standalone approach to prevent dividend washing, it would result in considerable uncertainty and would not be self-executing, resulting in significant compliance costs for taxpayers and administration costs for the Australian Taxation Office. For this reason, this approach may work better as a complement, rather than a substitute, to amending the holding period rules. Submissions should outline whether the approach should be taken as a complementary measure, a substitute measure, or not be taken at all.

3.4 Creating a specific double franking credit integrity rule

26. This approach would involve inserting a specific double franking credit integrity rule into the anti-avoidance provisions. In effect, the rule would operate similarly to the modifications to the holding period rule, but would be housed in Part IVA of the *ITAA* 1936. The rule would apply to ensure that when a shareholder sells an ex-dividend share after a share goes ex-dividend and then purchases a cum-dividend share before the record date, only one set of franking credits could be claimed.

27. A weakness with this approach is that Part IVA of the *ITAA 1936* is normally reserved for anti-avoidance rules that are general in nature, however, this approach would involve a specific anti-avoidance rule. Due to this concern, it may be more appropriate to modify the holding period rules. Submissions should outline if it would make more sense to create a specific anti-avoidance rule in the general anti-avoidance provisions, or to modify the holding period rules.

4. Background

4.1 Australia's imputation regime

28. Dividend imputation was introduced in 1987, primarily to eliminate the double taxation of company dividends. Under the dividend imputation regime, resident companies build up franking account balances by paying Australian company income tax. Companies can draw down on their franking account balances by attaching franking credits to dividends paid to shareholders, who can then use the credits to offset their personal income tax liability (or increase their refundable tax offsets) in Australia.

29. Two key principles support the imputation regime:

- franking credits should only be available to the true economic owners of shares (that is, those that bear the risk), and only to the extent that they can use them; and
- tax paid at the company level should be imputed to shareholders proportionately to their shareholdings.

30. Australia has integrity provisions to uphold these principles by preventing the trading of franking credits. Franking credit trading involves transferring franking credits to a taxpayer that has not borne the risk associated with the shares. The provisions aimed at preventing franking credit trading include:

- the general anti-avoidance rules (Part IVA of the *ITAA 1936*); and
- the holding period rules (former Division 1A of Part IIIAA of the *ITAA 1936* — currently being transferred to the *ITAA 1997*).

31. There are incentives for franking credit trading to occur whenever some shareholders value franking credits more than others. A commonly cited example of this type of arbitrage opportunity is between resident and non-resident shareholders.

32. Non-resident shareholders generally place a lower value on franking credits than Australian shareholders. While non-residents can use franking credits to offset dividend withholding tax in Australia, this benefit is usually undone for non-residents from countries that have tax treaties with Australia. This is because, under these treaties, dividend withholding tax paid in Australia is generally able to be credited against the personal income tax liabilities of non-residents in their country of residence. In addition, the dividend withholding rate may be well below the 30 per cent company tax rate. As a result, non-resident shareholders from treaty countries place a low value on franking credits, and have an incentive to trade them with shareholders who place a higher value on them.

33. Dividend washing is an example of franking credit trading. It violates the underlying principles of the imputation regime by enabling franking credits to be used by taxpayers that do not bear the risk of the shares, and enabling some shareholders to receive two sets of franking credits despite only having held one parcel of shares at any point in time. However, it is not clear that the existing integrity rules in the imputation regime prevent dividend washing from occurring in all circumstances. Therefore, amendments are needed to prevent dividend washing from occurring, and from growing into the future.

4.2 THE PROCESS FOR PAYING DIVIDENDS

34. Many ASX listed companies pay dividends twice per year in the form of an interim, and then a final dividend. However companies can choose how often to pay dividends.

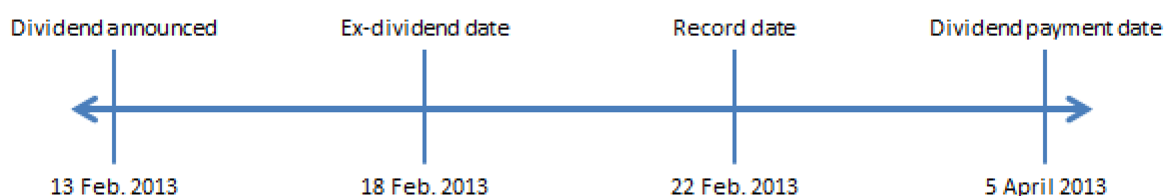
35. The first step in the distribution process requires the board of directors to declare a dividend, which is then announced to the market. The announcement includes details on the size of the dividend, the record date (and thereby the ex-dividend date — see below), and the dividend payment date.

36. The record date is the day on which a company closes its share register to determine which shareholders are entitled to a dividend.

37. While a company is not required to announce the ex-dividend date, under ASX procedures the date always comes four business days before the record date. A share goes ex-dividend on the ex-dividend date. As such, in order to be entitled to a dividend a shareholder will usually have to purchase shares before the ex-dividend date (that is, while the shares are still cum-dividend).

38. The dividend payment date is the date on which a company's dividend is paid to shareholders.

Diagram 2: Example of key dividend dates



4.3 HOW SPECIAL CUM-DIVIDEND MARKETS ARE ESTABLISHED AND OPERATE

39. Under ordinary trading conditions, the right to a future dividend cannot be traded during the four-day period between the ex-dividend date and the record date. However, shares traded on specially established cum-dividend markets are able to be traded with the right to the future dividend.

40. Special cum-dividend markets can be established by the ASX at the request of a Trading Participant during the two-day period after a share goes ex-dividend. They can only be established for a total period of two business days, and a request must be made to the ASX for their creation on each business day.

41. Special markets have existed for a number of years to support the options market, and in particular trading in Exchange Traded Options. Due to the ASX's overnight batch processing, a call writer of these options is not notified of whether their options have been exercised until the following business day. If the assigned call option writer is uncovered (that is, they do not already own the underlying shares), they will need to obtain the shares on a cum-dividend basis in order to deliver cum-dividend shares to the call option taker. It is in

these circumstances that a call option writer may request the establishment of a special cum-dividend market so that they can fulfil their contractual obligations.

42. The Government recognises the important role that special cum-dividend markets play in supporting the options market and Australia's financial system more broadly. As such, the Government will not limit legitimate trading on special cum-dividend markets.

4.4 Evidence of dividend washing

43. Shares in companies that regularly pay out fully franked dividends often experience trading spikes when they go ex-dividend. While the Government considers that a proportion of these spikes relates to dividend washing, it is likely that a large proportion relates to legitimate market activities. The motivation for these activities can relate to the dividend payments on shares, and even the attached franking credits, but do not represent abuses of the imputation regime. The Government does not intend to affect the operation of these activities.

44. To better understand the extent to which dividend trading exists, it is better to look at the volume of trades in special cum-dividend markets. However, as noted above, special cum-dividend markets exist for legitimate reasons, and therefore only a proportion of the trades in these markets relate to dividend washing.

45. In the five-month period from 1 July 2012 to 30 November 2012, special cum-dividend markets were established for the stocks of 59 companies. In this period, 16,829 trades were executed with a value of $3.58 billion. The value of trades represents approximately an average day's trading on the ASX, while the number of trades is significantly lower than the ASX's daily average of over 400,000 trades. This indicates that the trading on special cum-dividend markets is likely to be undertaken by sophisticated investors with large share portfolios.

46. The majority of the trades in special cum-dividend markets was linked to the shares of the big four Australian banks. This is likely due to the fact that these companies regularly pay out fully franked dividends and have significant market capitalisations.

5. Consultation process

5.1 Submissions

47. This discussion paper will be open to written submissions until the close of business on Monday, 17 June 2013. It would be preferable for submissions to be submitted electronically to: dividendwashing@treasury.gov.au.

48. It would be useful for submissions to address the following questions.

General questions:

- Which option/s would best prevent dividend washing from occurring?
- Would the options canvassed have unintended consequences for legitimate trading activities?
- Would the options canvassed create undue levels of uncertainty or complexity for taxpayers?

Specific questions:

- If modifications to the holding period rules were made, would the description of their application in this discussion paper provide taxpayers with enough certainty?
- If modifications to the holding period rules were made, should they be targeted to the period after a share goes ex-dividend on a time basis or concept basis?
- Should adding a criterion to the anti-avoidance rules be adopted as a complementary measure to modifying the holding period, a substitute measure, or not be adopted at all?
- Would it make more sense to modify the holding period rules or insert a specific double franking credit integrity rule to the general anti-avoidance provisions?

5.2 Consultation meetings

49. Due to the tight timeframes involved, consultations meetings will be organised on an as-required basis. Stakeholders interested in attending a consultation meeting should contact the Treasury using the contact details on Page ii of this discussion paper.

6. Process going forward

50. The Government will reflect on the views expressed in submissions before deciding on a legislative approach. This approach will be publically communicated before 1 July 2013 (the start date of the policy) to ensure that taxpayers are able to comply with the new arrangements with a minimal level of uncertainty. The finalised response will be drafted and legislated at a later date.