



6 October 2022

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Franked Distributions and Capital Raising Exposure Draft

The Corporate Tax Association (CTA) and Chartered Accountants Australia and New Zealand (CA ANZ) welcome the opportunity to make a submission to the Treasury in relation to the *Franked Distributions and Capital Raising Exposure Draft* (ED).

CTA is the key representative body representing 150 major companies in Australia on corporate tax issues advocating for a simple and efficient corporate tax system. Further information about the CTA can be found on our website at www.corptax.com.au.

CA ANZ represents more than 128,000 financial professionals, supporting them to build value and make a difference to the businesses, organisations and communities in which they work and live. Around the world, Chartered Accountants (CAs) are known for their integrity, financial skills, adaptability and the rigour of their professional education and training.

Executive Summary

In summary, our members have expressed concern that the ED is very broadly drafted with the possible result being franking credits denied (or distributions unfrankable) on many ordinary capital management activities, rather than being limited to artificial arrangements entered into to obtain inappropriate access to franking credits held by a company.

It is noted that the rationale for the law change was to deal with the artificial and contrived arrangements such as those in [Taxpayer Alert TA 2015/2: Franked distributions funded by raising capital to release credits to shareholders](#) (TA 2015/2). We note the Explanatory Memorandum (EM) makes no mention of the Taxpayer Alert as the context for the proposed law, hence the concerns expressed that the intent of the rules may be applied in wider circumstances.

To this end, it is critical that:

- the principal effect and purpose tests in subparagraph 207-159(1)(c) are amended; and
- the ATO publish a Law Companion Ruling and Practical Compliance Guideline as soon as practicable that provides clear examples of how the rules will operate in practice. The ATO guidance could deal with examples of equity raisings where there is a distribution similar to cases that have occurred since 19 December 2016 that are in the public domain. Similarly, the EM should be supplemented with relevant examples as well.

Our observations and details on our recommendations are set out in detail below.

1. Intent of Original Policy Announcement

The measure¹ announced in the 2016-17 Mid-Year Economic and Fiscal Outlook (MYEFO) provided that this measure was intended to be a specific measure 'preventing the distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities.' It provided:

The measure will apply to distributions declared by a company to its shareholders **outside or additional to the company's normal dividend cycle (a special dividend), to the extent it is funded directly or indirectly by capital raising activities** which result in the issue of new equity interests. Examples of capital raising activities include an underwritten dividend reinvestment plan, a placement or an underwritten rights issue.

Where such arrangements are entered into, the corporation will be prevented from attaching franking credits to shareholder distributions. [Emphasis added]

The measure was intended to address issues in TA 2015/2. TA 2015/2 appears primarily concerned with companies raising capital to release franking credits through an 'unusually large' franked distribution² compared to dividends previously declared and paid by the company with minimal impact on the company's net cash flow position, net asset position or shareholders. However, the franking account is 'significantly reduced'. Notably, the company makes the franked distribution 'at a similar time' to the capital raising 'in a similar amount' to the capital raised.

The announcement seems similarly targeted to distributions made outside or in addition to the company's normal dividend cycle, referring to 'special dividends', where the special dividend is funded directly or indirectly by capital raising activity of a similar amount. Examples of typical capital raising activities, such as a dividend reinvestment plan, are given.

It is apparent from the above the policy intent is to target the specific circumstances where capital raising activities are used to fund the distribution of dividends with franking credits attached outside a company's normal dividend cycle that otherwise

¹ Pp112-13 [2016-17 Mid-Year Economic and Fiscal Outlook](#)

² A distinction is drawn to exclude a typical dividend reinvestment plan applicable to an ordinary regular dividend here.

have minimal impact on the net asset or net cash flow position of the company. In this regard, there should be limited circumstances where this measure should apply to deny the distribution of franking credits.

Further, we note the ATO's comments in the 2021 Reportable Tax Positions Schedule Findings Report regarding disclosures required for TA 2015/2:

Funding special dividends and buybacks – Question 2 disclosures³

There were no disclosures at question 2 in 2019–20. Question 2 relates to equity raising to fund special dividend or share buyback arrangements.

We have continued to monitor the risk associated with arrangements described in Taxpayer Alert TA 2015/2. Our risk identification processes and assurance programs have confirmed these arrangements are no longer prevalent in the large public and multinational business population. This gives us confidence we don't have a non-disclosure risk.

Specifically, the ATO noted these arrangements are no longer prevalent in the large public and multinational business market segment. Therefore, given the concern which has arisen amongst large businesses in response to this measure, we query whether the integrity measure is appropriately targeted to the relevant market segment.

2. Application of the Exposure Draft

General

Paragraph 1.16 of the Explanatory Memorandum (EM) provides:

These amendments are an integrity measure. They prevent entities from manipulating the imputation system to obtain inappropriate access to franking credits. They will specifically prevent the use of artificial arrangements under which capital is raised to fund the payment of franked distributions to shareholders and enable the distribution of franking credits.

While the EM provides that this measure will 'specifically prevent the use of artificial arrangements under which capital is raised to provide funding to enable a company to extract and attach franking credits to a distribution it may not otherwise have the funding to do, our concern is that the measure is broadly drafted and will capture ordinary capital raisings and capital management activities that are not 'artificial arrangements' intended to be targeted by this measure.

Establishing an entity's 'practice' – the subsection 207-159(1)(a) condition

Draft subsection 207-159(1)(a) looks to the practice an entity has of making distributions. It is clear the subsection is intended to distinguish a 'relevant distribution' that is funded by a capital raising that is out of the entity's ordinary distribution cycle.

³ <https://www.ato.gov.au/Business/Large-business/Compliance-and-governance/Reportable-tax-positions/Findings-report-Reportable-tax-position-schedule-Category-C-disclosures/>

However, it is unclear what the phrase 'of a kind' in subsection 207-159(1) and in subparas (a)(i) and (ii) is referring to:

- a) whether this is referring to the entity's regular cycle of ordinary franked distributions (e.g., a typical interim and final dividends cycle in the case of a publicly listed company) where a distribution funded by capital raising would not be 'regular'; or
- b) whether this is referring to distributions made on a regular basis that are funded by capital raising and the provision is directed at a distribution funded by capital raising that does not fit in with the regularity of the other distributions.

This needs to be clarified.

The 'principal effect' and 'purpose' tests – the subsection 207-159(1)(c) condition

Draft subsection 207-159(1)(c) provides the 'condition':

it is reasonable to conclude having regard to all relevant circumstances that:

- (i) the **principal effect** of the issue of any of the equity interests was the direct or indirect funding of the relevant distribution or part of the relevant distribution; or
- (ii) any entity that issued, or facilitated the issue of, any of the equity interests did so **for a purpose** (other than an incidental purpose) of funding the relevant distribution or part of the relevant distribution.
[Emphasis added]

The 'principal effect' test is explained at paragraph 1.30 of the EM as being satisfied if 'in all of the relevant circumstances, it is reasonable to conclude that the **main or most significant consequence** of the issue of equity interests was funding the making of some or all of the distributions.' Paragraph 1.31 of the EM goes on to explain:

If an issue of equity interests has a number of effects, one of which is directly or indirectly funding some or all of a franked distribution, then this test will only be satisfied if this was the main or leading effect of the issue of equity interests.

The 'purpose' test is explained at paragraph 1.32 to be satisfied if 'in all the relevant circumstances, it is reasonable to conclude the entity that issued the shares or an entity that facilitated the issue of the shares did so for a purpose of generating funds for the making of all or part of the distribution'. Paragraph 1.33 of the EM goes on to explain:

It is not necessary that the relevant purpose be the sole, dominant or primary purpose of the entity, only that it was more than incidental to some other purpose. Likewise it is not necessary that the purpose is a purpose of the entity that issued the equity interest. It is only necessary that an entity that was involved in facilitating or bringing about the issue of the equity interests did so with such a purpose. This ensures that, for example, the purposes of advisers and related parties can be taken

into account. It ensures there are no incentives to engage in artificial arrangements on behalf of other entities.

Paragraph 1.34 of the EM tries to explain why both tests have been included:

The difference between the two tests is that the 'principal effect' test looks at the outcome, while the 'purpose' test looks at the intention. The inclusion of the two tests ensures the provisions apply where either the intention or effect of a capital raising is to fund a distribution.

Paragraph 1.27 of the EM says:

The final requirement for a distribution to be unfrankable builds on the second requirement by providing that it must be reasonable to conclude that, having regard to all of the relevant circumstances, the issue of an equity interest or interests must have (whether directly or indirectly) either:

- had the principal effect of funding the distribution or part of a distribution; or
- been undertaken or facilitated by at least one entity for **the purpose of achieving that result**. [Emphasis added]

By inclusion of the words 'for the purpose of achieving **that result**', being the result of having the principal effect of funding part or all of the distribution, paragraph 1.27 of the EM implies the 'purpose' test is designed to link back to the 'principal effect' test to tie the purpose (intention) back to the principal effect (outcome).

The 'purpose' test is currently drafted as an alternative to the 'principal effect' test and seems to substantially broaden the test to include a purpose other than an incidental purpose regardless of the main or most significant consequence of the distribution. However, as noted above, paragraph 1.30 of the EM provides the 'principal effect' test is satisfied if it is 'reasonable to conclude that the **main or most significant consequence** of the issue of equity interests was funding the making of some or all of the distributions. One of many purposes for raising capital could be to fund a distribution (or part of a distribution). Without the purpose test being directed to the 'principal effect' of the equity issue, the test casts the net very wide on the kinds of capital management activities that could inadvertently be caught up by these provisions.

A simple example

Assume an Australian publicly listed entity has \$10 of retained profits and could distribute a fully franked dividend of \$10 if it had the funds. It is cash-strapped. It wants to pay a \$10 fully franked dividend and needs to raise \$90 for working capital outside its normal dividend cycle. It considers options to borrow \$100 from its bank or undertake a public equity raising. It decides to go to the market and raises \$100 by an equity issue. The next week it uses \$10 to distribute a dividend and thus retains \$90 to fund the business.

While the principal effect of the \$100 equity issue is to raise \$90 working capital, a not incidental purpose is probably the payment of the \$10 dividend.

The draft provision, on its face, would appear to make the distribution unfrankable even though the company has retained profits, franking credits and has grossed up

its balance sheet by \$90. By contrast, if the company borrowed \$100, paid a \$10 dividend (grossing up its balance sheet the same amount), the distribution would be frankable.

The policy rationale to treat an equity raising as unfrankable whereas a borrowing results in a frankable distribution, when there is no contrivance or artificiality, is puzzling as:

- The rationale behind the imputation regime was to align the post-tax treatment of debt and equity. By allowing a borrowing to fund a franked dividend, but not allowing an equity raising to do the same introduces a distortion. It encourages debt financing of dividends. It potentially strains the balance sheets of those that may already be strained.
- Tax has been paid on retained profits. Equity issuances by their nature may involve shareholders who weren't shareholders when the profits were derived obtaining a future franked dividend. If the shares are issued at market value, while the existing shareholder may obtain a less proportionate right to historic franked profits, they do not lose from the equity issuance if issued at market value. The rules should, as a minimum, not apply to private companies where ultimate shareholders have not changed from the time the retained profits were derived and the equity raising.
- It can lock in franking credits to shareholders who were beneficially entitled to historic retained profits. While in a wholly-owned private group this may not be an issue, it has implications for the normal churning of public share ownership. While we accept "round robin" dollar for dollar arrangements are egregious, to design rules that assume every distribution with a link to an equity issuance (being contemporaneous with, or close to, the payment of a franked dividend, however small that dividend is relative to the equity raising) and assume they are bad (as someone may not have an incidental purpose to pay a franked dividend from the equity raising), overplays the integrity concerns. With respect, the policy is seeing franking credit ghosts. It will require every public and private company making a distribution with any tenuous temporal link to an equity raising to obtain an ATO ruling, unless there are clear practical guidelines that assist in targeting the practical effect of the integrity rules to contrived arrangements. Guidelines need to also protect taxpayers that rely on that guidance. Without this, the rules as drafted add deadweight compliance costs to both the ATO and companies, and ultimately the community.

Alternatively, the entity may have enough cash reserves to fund the \$10 distribution, pays out the distribution and subsequently decides to raise equity to replenish its cash reserves. It also seems inappropriate in this case to treat the distribution as unfrankable.

In our view, the simplest way to deal with the issue is to have the 'purpose' test reworded and be directed at a purpose that has the principal effect of funding the distribution.

Recommendation

We suggest the following amendment to subparagraph 207-159(1)(c)(ii) in red below:

- (ii) any entity that issued, or facilitated the issue of, any of the equity interests did so for a purpose (other than an incidental purpose) **which has the principal effect** of funding the relevant distribution or part of the relevant distribution.

Alternatively, the “or” between subparagraphs 207-159(1)(c)(i) and (ii) should be replaced with “and”.

Impact on Private Groups

The requirement in subparagraph 207-159(1)(a)(ii) that the entity does not have a practice of making distributions of that kind on a regular basis would almost always be satisfied for companies in private groups which generally do not have a normal practice of paying dividends (these are usually smaller private groups).

With the inclusion of the ‘principal effect’ test, the provisions as currently drafted are broad enough to inadvertently capture companies in smaller private groups. For example, some family run companies pay their shareholders (who run the business) a dividend in lieu of a salary as they prefer to “pay” themselves after they know the financial position of the business at the financial year end. If this occurs at a similar time to an issue of shares or other equity interests, then the shareholder could be denied franking credits on the dividend which seems unfair considering the franking credits represent tax already paid and the shareholders would be taxed at their marginal tax rates on the dividend received.

Furthermore, the definition of “equity interest” is quite broad and could capture at-call loans made to a company, which is a financing arrangement used in private groups. Although there are exceptions to “equity interest” treatment for at-call loans under sections 974-75(4)-(6) in the *Income Tax Assessment Act 1997* (Cth) (1997 Act), these exceptions will not always apply.

Context of the draft provisions

The provisions must also be read in the context of Subdivision 207-F of the 1997 Act, which is titled ‘No gross-up or [tax offset](#) where the [imputation system](#) has been manipulated’. Further, section 207-140 describes what Subdivision 207-F is about and provides:

This Subdivision creates the appropriate adjustment to cancel the effect of the gross-up and [tax offset](#) rules where the [entity](#) concerned has manipulated the [imputation system](#) in a manner that is not permitted [under](#) the [income tax law](#).

It may be helpful if language similar to that used in the title to Subdivision 207-F and in section 207-140 is used in draft section 207-159 to serve as a reminder that the draft provisions are targeting distributions funded by capital raising that manipulate the imputation system.

3. Guidance is required

Concerns with the drafting of the Exposure Draft and lack of examples in the EM illustrating how the provisions are intended to apply have caused consternation among taxpayers about the breadth of application of the provisions and whether the draft provisions go beyond the scope of the announced measure.

To this end, it is critical that the ATO publish a Law Companion Ruling and Practical Compliance Guideline as soon as practicable that provides clear examples of how the provisions will operate in practice. The ATO guidance could deal with examples of equity raisings where there is a distribution similar to cases that have occurred since 19 December 2016 that are in the public domain to demonstrate how the equity raising and distribution may be linked, or not, under the rules. Examples showing how an issue of equity in an unrelated entity to the entity that makes the distribution would also be useful to demonstrate the intended scope of the rules. Examples of ordinary capital management activities (discussed further below) that are not intended to fall within the scope of the rules would also be helpful.

Similarly, the EM should be supplemented with relevant examples as well.

4. Ordinary capital management activities

We seek clarification of what kinds of capital management activities are intended to be targeted by this measure. While the policy announcement is clear that 'out of cycle' distributions that arise from 'artificial arrangements' are the intended target, as demonstrated above, the measure appears to have been drafted much more broadly.

Based on the current drafting, there are certain capital management activities that prima facie appear to be caught up in the application of the rules. These could include equity raising to fund acquisitions, dividend reinvestment plans (including underwritten plans), capital returns and share buy-backs. We do not consider this measure is necessarily intended to apply to these activities.

In the absence of a specific carve-out for these ordinary capital management activities (or clear guidance on how the provisions work in practice), distributions that form part of these transactions are at risk of being deemed unfrankable.

The policy announcement referred to 'examples' of capital raising activities including an underwritten dividend reinvestment plan. We note that whether the equity interest was underwritten is a factor to be taken into account in determining whether the purpose test or principal effect test applies. While paragraph 1.46 of the EM notes '[t]he extent and nature of underwriting arrangements for an issue of equity interests is an important indication of whether the capital raised from the issue is guaranteed, which may inform its purpose and effect', it is not clear whether this factor has a positive or negative effect. This should be clarified.

5. Practical Impact of Retrospective Application

Appropriateness of the retrospective application of the provisions

Given the retrospective application of the measure to 19 December 2016 and the breadth of the application of the measure as currently drafted, there are likely to be numerous historical franked distributions caught up in the draft measure not originally envisaged to be caught based on the original wording of the measure as announced.

In particular, historical franked distributions made near ordinary capital management activities maybe inadvertently be caught. Based on the original 2016-17 MYEFO announcement, it is not apparent that companies would have to test for the principal effect of their capital raising activities and their decision to declare dividends. Furthermore, companies would not have been able to apply to the ATO for a class ruling for their capital raising activities as the announcement was not law and the ATO can only administer the law as is enacted at the relevant time.

Should the legislation remained unchanged, we recommend that the legislation not apply retrospectively to franked distributions inadvertently caught by the 'principal effect' test unless the 'purpose' test can also be satisfied.

Protection should also be given to shareholders who may have received distributions in the past.

Ability to amend assessments outside existing period of review

The draft legislation also allows the Commissioner to amend assessments outside the existing period of review to give effect to the retrospectivity of the measure as long as the amendment is made within 12 months after the commencement of the legislation.

According to paragraph 1.56 of the EM, "[t]his is necessary because the measures prevent artificial and contrived arrangements set up to inappropriately access franking credits that were not intended under the imputation system." As the draft legislation currently goes beyond artificial and contrived arrangements, the ability for the Commissioner to amend assessments outside the existing review period seems unduly harsh for those shareholders who have no influence over a company's decision-making, especially the retail individual and superannuation fund investors in public companies that may be caught by this measure.

Furthermore, it may be difficult for the ATO to enforce this measure by amending all the assessments of the shareholders who have received affected franked distributions since 19 December 2016, particularly where the distributions are paid to trusts where there can be complex flow-on effects.

Administering the measure

There will be practical difficulties for the ATO in recouping franking credits that have been paid out to shareholders that have received a franked distribution, and lodged their income tax return on that basis, if, following the enactment of the measure, that distribution is subsequently determined to be unfrankable. This will likely be an unwieldy process requiring many shareholders' tax returns to be reassessed which will cost the ATO significant compliance resources.

The ATO will need to provide guidance on how it intends to apply its compliance resources in these circumstances to the distributing entity and the affected shareholders. The ATO will also have to provide guidance on the impact of withholding tax obligations for affected distributions paid to non-resident shareholders.

Guidance will also be required from the ATO regarding how the ATO intends to administer the measure going forward.

Yours sincerely,



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