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Franked distributions and capital raisings - Submissions in response to consultation by Treasury

Introduction

We refer to the exposure draft legislation *Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings (Exposure Draft)* released for public comment on 14 September 2022 and the invitation by Treasury for submissions on the Exposure Draft and the accompanying Explanatory Material.

King & Wood Mallesons welcomes the opportunity to make a submission on the proposed measure. As a firm, we have acted for many corporations in relation to capital raisings, the tax implications of distributions and general corporate and governance advice. Based on our experience, we consider that the Exposure Draft may have significant consequences for companies and shareholders. More fundamentally, we do not consider that the proposed measure is required.

Executive summary

For the tax system to be effective, it is important for taxpayers to have certainty regarding their tax position.

Our main concerns with the Exposure Draft, which are elaborated on below, include:

- **(lack of clarity around the current need for the measure and the mischief being addressed)** it is unclear why the Government now considers it necessary to enact legislation first contemplated in 2016. In particular, the previous Government appeared to have moved on from the policy. It is also not clear that the perceived mischief being addressed is based on a policy underlying the imputation system.
- **(policy of the measure)** the concept of the measure creates inappropriate commercial outcomes. It results in differential rules which apply to companies which make periodic dividends. In effect, it introduces a commercial bias to not pay dividends outside a periodic dividend policy. This is an inappropriate commercial limitation.
- **(general application of the measure)** the test proposed for the application of the measure is broadly drafted and sets a low threshold for activities captured by the measure. Also, under the

proposed measure, the entire distribution ceases to be able to be franked even if the test is satisfied only in relation to some of the capital raised or part of a franked distribution.

- **(impact on funding structures)** the measure creates an inappropriate difference between funding choices for corporations. These choices are not based on tax considerations.
- **(retrospective application)** the measure applies retrospectively to distributions made on or after 19 December 2016. This would impact the position of shareholders who received franked distributions at a time when the precise scope of the measure was not clear.
- **(broader application than previously foreshadowed)** the measure appears to go beyond transactions that might attract the operation of section 177EA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), which was mentioned in Taxpayer Alert 2015/2 (TA 2015/2) and discussed in the *2016-17 Mid-Year Economic and Fiscal Outlook (2016 Announcement)*. The measure also appears to have broader application than was contemplated in TA 2015/2 and the 2016 Announcement.

Therefore, we submit that:

- (a) the measure should not be legislated; or
- (b) if the measure is to be legislated:
 - (i) it should be amended to ensure it has a more appropriate scope; and
 - (ii) it should not apply retrospectively.

Background

On 7 May 2015, the Australian Taxation Office (ATO) issued TA 2015/2. TA 2015/2 set out certain arrangements the ATO was reviewing. These involved:

- a company with significant franking credits raising new capital from existing or new shareholders (e.g. through a renounceable rights issue);
- at a similar time to the capital raising, the company making franked distributions to its shareholders in a similar amount to the amount of capital raised (e.g. as a special dividend or through an off-market share buy-back);
- the franked distributions (or franked component of buy-back consideration) may be unusually large compared to ordinary dividends previously declared and paid by the company (as distinct from a typical dividend reinvestment plan applicable to an ordinary regular dividend); and
- the payment of the distribution by the company having minimal impact on the company's net cash flow position, net asset position or shareholders, but with the franking account being significantly reduced.

The ATO was concerned that such arrangements released franking credits or streamed dividends to shareholders in circumstances where the franking credits would have otherwise been retained by the company, in a way that might attract the operation of the anti-avoidance rule in section 177EA of the ITAA 1936, or other anti-avoidance rules.

In the 2016 Announcement, the Government announced its intention to introduce an integrity measure that would prevent the distribution of franking credits where a distribution to shareholders is funded directly or indirectly by particular capital raising activities.

Under proposed section 202-45(ea) of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), a distribution will be unfrankable where:

- (a) the distribution in question is distinct from an established practice of the entity making the distribution (if any);
- (b) there is an issue of equity interests in the entity (before, at, or after the time the distribution in question was made); and
- (c) it is reasonable to conclude having regard to all relevant circumstances that:
 - (i) the principal effect of any of the equity interests issued was the funding (directly or indirectly) of the distribution (or any part thereof); or
 - (ii) any entity issuing (or facilitating the issue of) any of the equity interests had the purpose (not including an incidental purpose) of funding the distribution (or any part thereof).

At first glance, the Exposure Draft appears to merely implement the measure announced in the 2016 Announcement and first raised in TA 2015/2.

In our view, the measure has broader application than the previous announcements.

Further, there are a number of concerns with the drafting and potential application of the measure. In turn, this makes the tax position of taxpayers and shareholders uncertain, particularly where the measure is applied retrospectively.

Details of our concerns with the measure

(a) Unclear why the measure is now needed and the mischief being addressed

The Explanatory Materials accompanying the Exposure Draft state that the proposed amendments are designed to 'prevent entities from manipulating the imputation system to obtain inappropriate access to franking credits'.

The 'mischief' to be addressed is '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'.

TA 2015/2 provides that the ATO was concerned about arrangements releasing franking credits that may otherwise have been retained by the company. One policy underlying the imputation system is that there should be a certain level of 'wastage' of franking benefits.

It is our view that section 177EA is designed to apply to those arrangements that have the effect of ensuring that surplus franking credits are directed to those shareholders who are best able to utilise the credits and away from those who are disadvantaged in respect of franking credits. That is, in assessing whether section 177EA applies to an arrangement that avoids the potential wastage of franking credits the issue is whether, in form or substance, the arrangement facilitates franking credit trading or dividend streaming, and not simply whether it releases franking credits that would otherwise be retained.

In other words, when considered in light of the broader rationale for allowing imputation benefits to taxpayers, the hallmark of a scheme which avoids the wastage of franking credits and to which section 177EA applies is an arrangement (which may include deferral of distributions) which ensure that surplus franking credits are directed to shareholders who are best able to utilise the credits and away from disadvantaged shareholders.

In that context, a measure potentially aimed at preventing the release of franking credits that may otherwise have been retained is unnecessary. This should not be a policy underlying the imputation

system unless there is also a broader strategy of dividend streaming to avoid wasting franking credits. For such strategies, section 177EA should apply.

Therefore, we consider that the proposed measure is unnecessary and should not be legislated.

Further, following TA 2015/2, the ATO provided an update at the 27 November 2015 meeting of the ATO Tax Practitioner Advisory Group.

Relevantly, the update included that the ATO would issue additional market guidance for payer companies 'in early 2016 to provide further certainty regarding those transactions we consider to be low compliance risk, and those we consider to be high compliance risk'. That guidance was never issued.

This could suggest that the ATO may have considered the release of TA 2015/2 sufficient to put taxpayers on notice in relation to the arrangements flagged as being reviewed (e.g. capital raisings funding special dividends). This is supported by the ATO's comments in the 2021 Reportable Tax Positions Schedule Findings Report. In this report, the ATO states that:

Our risk identification processes and assurance programs have confirmed [that arrangements relating to equity raising to fund special dividend or share buyback arrangements] are no longer prevalent in the large public and multinational business population.

Indeed, the previous Government appeared to also have moved on from the policy, or had no interest in legislating the policy following the 2016 Announcement. It is worth highlighting that the measure was only estimated to have a gain to revenue of \$30 million over the then forward estimates period (i.e. \$10 million per year).

If the measure is to be legislated, it should be clearly articulated why it continues to be required and the estimated gain to revenue on both a retrospective and prospective basis.

(b) Policy of the measure

At its core, the measure does not allow a company the flexibility of using cash generated through profits, which have been reinvested, without the risk that a subsequent capital raising would practically prevent a distribution of the profits (such profits having been fully taxed).

The tax mischief that appears to be the focus of the measure is a mismatch between the level of franking credits available to attach to a dividend and the cash resources of the company available to pay the dividend.

However, the ability of a company to pass franking credits to its shareholders should not be determined by the manner in which the company manages the cash resources generated through the profits that were subject to tax and which generated franking credits.

It is an inappropriate commercial limitation that a company could raise capital to pay its working capital expenses, thereby retaining cash resources that could be used to pay a special dividend, but that the same company could not pay a special dividend if it used cash resources generated through periodic profits to do so and subsequently raised capital.

Indeed, the availability of franking credits should be dependent on profits, not upon the source of the cash resources used to pay a dividend.

We regard section 177EA as more than adequate for dealing with the relevant concern of the inappropriate allocation of franking credits on dividends paid to shareholders. This provision, other existing provisions dealing with such arrangements, and other provisions dealing with off-market share buyback arrangements, are sufficient for enforcing the policy.

(c) Mismatched treatment between debt and equity

In addition to the discussion in paragraph (a) above about whether the measure is needed, it is unclear why a measure is needed in relation to raising funds by issuing equity, whereas there is no equivalent measure with respect to distributions funded by debt (e.g. dividend recapitalisations).

TA 2015/2 provides that the Commissioner is concerned with arrangements entered into where, overall, the net asset position of the company remains essentially unchanged but their franking account is significantly reduced. It appears that the concern of the ATO raised in TA 2015/2 is that if a scheme does not result in any real and substantive change in the financial position of the company then, as a matter of substance, the only thing that the scheme achieves is a release of franking credits.

If that is the case, the ATO's position appears to be that there is a divergence in the form and substance of the scheme and, objectively, this is indicative of there being a more than incidental purpose of enabling the relevant taxpayer to obtain imputation benefits.

It is not clear whether this view is a concern of the Government and whether it underpins the release of the Exposure Draft. However, if it is, then the apparent bias towards raising debt to fund franked distributions does not recognise, in each case, that the financial position of the company raising funds is different before and after the transactions in a real and potentially substantive way.

The source of a distribution and the source of funds used to pay the distribution will often be different. For example, if additional equity is raised by way of the issue of shares and a distribution is paid from existing retained profits, future distributable profits are reduced. The equity accounts of the company would, as a matter of form and substance, be different before and after the transaction. This will also be relevant for financial ratio purposes and will have flow-on effects (e.g. debt covenants in loan documents, ratings agencies and stock market participants).

We consider this provides further support for why the measure is not required.

(d) Operation of the measure

Under proposed section 202-45(ea) of the ITAA 1997, an entire distribution will be unfrankable where the distribution satisfies the test in proposed section 207-159 of the ITAA 1997.

We are concerned with the current drafting of section 207-159, particularly with respect to:

- (i) The disaggregation of the part of the equity interest that funds (part of) the distribution when there is an 'effect or purpose' test that needs to be satisfied. When testing the effect or purpose, it should only be necessary to have regard to the part of the equity interest that funds (part of) the distribution.
- (ii) The low threshold for satisfying the 'effect or purpose' test, in that incidental purposes are not excluded. This is compounded by the issue described above at (i) when it is applied to the part of the equity interest that funds (part of) the distribution.

In relation to (i) above, we are concerned that this is disproportionate to the perceived mischief to be addressed by the measure. It means the entire distribution ceases to be able to be franked even if the test is satisfied only in relation to:

- some of the capital raised from an issue of equity interests; or
- part of a franked distribution.

That is, it appears that it is sufficient for the measure to apply where the purpose of an equity raising was only to fund a part of the distribution directly or indirectly. It is unclear why the whole

distribution should cease to be frankable, when the capital raising activity only funds a part of the distribution. Given the nature of the impact of the measure, if it is to be legislated then it should apply only if regard is had to the issue of the equity interest as a whole, and the relevant distribution as a whole.

In short, if there is to be a specific provision dealing with distributions funded by capital raisings (which we do not believe is appropriate or necessary) then section 207-159(1)(c) should be amended to read as follows:

- (1) This subsection applies to a distribution (the *relevant distribution*) of a kind made by an entity if all of the following conditions are satisfied:

...

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

- (i) the principal effect of the issue of the equity interests was the direct or indirect funding 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~~.

(e) Retrospective application

The measure will apply retrospectively to distributions made on or after 19 December 2016.

We are particularly concerned that the retrospective application, combined with the broad drafting, could impact the position of shareholders who have received franked distributions and made good faith decisions on this basis.

There is the potential for the measure to apply to historical franked distributions not originally envisaged to be caught based on the wording of TA 2015/2 and the 2016 Announcement. Any adjustments made to the franking credits attached to past distributions will not only potentially affect the franking accounts of corporate taxpayers, but could also cause corresponding adjustments to the tax position of shareholders who received those franked distributions. Compounded by our submissions above, we believe it is appropriate for the measure to only apply prospectively.

At the 27 November 2015 meeting of the ATO Tax Practitioner Advisory Group, the ATO stated, when providing an update in relation to TA 2015/2, that:

it [was] likely that determinations would only be made at the shareholder level for the most egregious of arrangements or those that involve significant streaming where the attributes of the shareholder are one of the reasons for the streaming.

No such statement is made in the Explanatory Materials accompanying the Exposure Draft, or in the Exposure Draft itself. Therefore, it is unclear whether this position would be applied if the measure was enacted in the form in the Exposure Draft. If the measure is legislated, then guidance will be needed from the ATO regarding:

- the practical impact on the company that made the distribution and the shareholders that have received the distribution; and
- how the ATO intends to apply compliance resources in reviewing past and future distributions.

We note that the 2016 Announcement flagged that the measure, when introduced, would apply retrospectively. Nonetheless, we consider that it is inappropriate for the measure to apply retrospectively as it would cause significant uncertainty for taxpayers and shareholders. The retrospective application of the measure is particularly significant following the period of instability and uncertainty in capital markets during the COVID-19 pandemic, which led to regulators providing a number of concessions, and companies taking a range of measures to continue to operate during this time.

Approximately 110 of the ASX200 entered into approximately 400 capital raising transactions between 1 March 2020 and 31 December 2021. A large number of ASX200 companies also paid dividends during that time. We understand that a smaller number of companies both raised equity and paid a dividend in that period.

The Commissioner will have 12 months after the amending legislation receives Royal Assent to amend prior year assessments to give effect to the amendments, even if doing so would be outside the existing period of review.

Again, as the Exposure Draft currently goes beyond artificial and contrived arrangements, we are concerned with the ability for the Commissioner to amend assessments outside the existing review period given most shareholders have no influence over a company's decision to pay a franked distribution and to raise equity.

Therefore, if the measure is to be enacted (either in its current or an amended form), we believe that it should have prospective application only from the date of Royal Assent of the enabling legislation.

(f) Unintended consequences beyond the intended policy behind the measure

We note that the original concern raised in TA 2015/2 was that the scrutinised transactions could be challenged under section 177EA. As mentioned above, the Explanatory Materials also provide that the measure will 'specifically prevent the use of artificial arrangements under which capital is raised' to provide funding to enable a company to pay franked distributions it may not otherwise have the funding to do.

However, our view is that the broad drafting of the measure means it may go beyond such transactions - and transactions that were contemplated by TA 2015/2 and the 2016 Announcement - and affect other transactions that are not 'artificial arrangements' or a manipulation of the imputation system and that we consider to be market practice.

As noted above, a significant number of other transactions may fall within the scope of the measure. Two particular examples of the potential unintended consequences for companies, shareholders and capital markets (and their participants) of the measure include:

- **Start-ups:**

Fast-growing small- and medium-sized companies, including start-ups, would be impacted by the new rules. In the absence of profits, these companies typically fund their early growth by raising capital from shareholders, to whom they aim to eventually pay dividends. Without a

practice of making distributions on a regular basis, the measure could apply to early distributions by such companies.

- **Dividend reinvestment plans:**

A strict reading of the Exposure Draft may mean the measure captures distributions that are accompanied with dividend reinvestment plans.

By definition, dividend reinvestment plans involve the payment of dividends that are simultaneously reinvested by the shareholder, resulting in a capital raising by the company. As mentioned, the entire distribution ceases to be frankable even if the test is satisfied only in relation to some of the capital raised from an issue of equity interests or part of a franked distribution. Therefore, there is a risk such plans could result in distributions being unfrankable.

If the measure is to be legislated then the ATO should publish guidance as soon as practicable that provides clear examples of how the rules will operate in practice. This could be in the form of a Law Companion Ruling and Practical Compliance Guideline. The ATO guidance should include examples of the types of capital management activities that the measure is intended to apply to. Similarly, the Explanatory Materials should be revised to include relevant examples.

Our submissions and contacts

We make these submissions on behalf of our firm, and the views expressed are our own and not those of any clients.

We would welcome the opportunity to discuss these submissions with The Treasury.

Yours faithfully

