Friday, 31 March 2023

Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee

Treasury Laws Amendment (2023 Measures No. 1) Bill 2023

Submission on Schedule 5 - Franked distributions funded by capital raisings

Chartered Accountants Australia and New Zealand (CA ANZ) and CPA Australia represent over 300,000 professional accountants who work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

We welcome the opportunity to provide comments on Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 (the Bill). In this joint submission, we comment on Schedule 5 of the Bill dealing with franked distributions funded by capital raisings. We have also provided comments on Schedules 1, 2 and 3 of the Bill in other joint submissions with other professional and industry bodies.

CA ANZ and CPA Australia support a measure that prevent entities from manipulating the imputation system to facilitate the inappropriate release of credits through the use of artificial arrangements. However, any such measure must be appropriately targeted, for otherwise it will impede common capital management strategies.

Schedule 5 should not be enacted in its current form

We believe the drafting in Schedule 5 is unnecessarily broad, making it difficult for companies to practically apply proposed section 207-159 of the *Income Tax Assessment Act 1997* (ITAA 1997). The lack of specificity in the provisions and insufficient guidance in the Explanatory Memorandum (EM) means that companies will be heavily relying on the Australian Taxation Office (ATO) to provide sufficient certainty to enable companies to progress with their capital management strategies.

In view of the broad application of the new section, the uncertainty it creates for Australian companies and their shareholders, and the need for ATO guidance (and probably private rulings) to practically apply the new section, the 15 September 2022 application date to distributions is now untenable.

Our detailed comments on Schedule 5 are set out in the attached appendix.

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Yours sincerely,

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Schedule 5

Schedule 5 to the Bill limits the ability of corporate tax entities to make franked distributions funded by certain capital raisings. It does this by adding distributions funded by certain capital raising to the list of distributions that are unfrankable.

Representations to CA ANZ and CPA Australia

CA ANZ and CPA Australia have sought and received input from our members in public practice and members who work in-house in corporations. The feedback in this joint submission reflects our members' views.

Will large companies and their shareholders be adversely impacted by the 15 September 2022 start date?

The provisions of Schedule 5 will apply to relevant distributions made on or after 15 September 2022, to align with the release of the Exposure Draft for public consultation on 14 September 2022.

Since that date, we are aware that a number of *informal* discussions occurred with Treasury officials about the scope of the measure, particularly insofar as it impacted large, listed companies.

The advocacy of these companies is now to some extent reflected in the Bill before Parliament, specifically proposed section 207-159(1) – which considers whether the distribution is not consistent with an established practice of the entity making distributions of that kind on a regular basis.

Committee members should note that the drafting of section 207-159(1) is an improvement on the equivalent draft sub-section which appeared in the draft Bill published for consultation and read as follows:

> **207-159 Distributions funded by capital raising**
>
> *(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:*
>
> > *(a) either:*
> >
> > > *(i) the entity has a practice of making distributions of that kind on a regular basis and the relevant distribution is not made in accordance with that practice; or*
> > >
> > > *(ii) the entity does not have a practice of making distributions of that kind on a regular basis;*
> >
> > *(b) there is an issue of *equity interests in the entity or any other entity (whether before, at or after the time at which the relevant distribution was made);*
> >
> > *(c) 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;*

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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.

The draft version of section 207-159(1) quoted above was regarded with alarm in some quarters as potentially capturing dividend reinvestment schemes which – depending on a listed company's circumstances – are commenced for the first time, suspended temporarily, or terminated and later re-commenced. There has also been substantial concern raised within the accounting profession for:

- Any "special" dividends paid, and
- The ramifications of Schedule 5 for capital raisings

during the consultation period and prior to the delayed enactment date.

CA ANZ and CPA Australia note that such capital management activities are likely to have been motivated by clear commercial (not franking) considerations (especially given the warning from the ATO in Taxpayer Alert TA 2015/2: Franked distributions funded by raising capital to release credits to shareholders). For example, the current rising interest rate environment has prompted many companies to refinance using equity rather than rolling-over debt financing arrangements.

In view of the Government's current priorities for legislation before Parliament and other priority measures, there is also concern that the Bill will not receive Royal Assent until the Spring Sittings. With the ATO yet to publish public guidance on the new rules, it is unlikely that there will be any certainty about how the provisions are to apply before the end of 2023. This will leave companies and their professional advisers in limbo for the rest of 2023 with respect to their current capital raising plans.

Finally, the Committee is expected to receive representations from impacted companies or the organisations that represent them.

Assuming Schedule 5 remains in the Bill, CA ANZ and CPA Australia recommend that the application date be deferred to the date of Royal Assent of the Bill. That is, Schedule 5 should apply to distributions made on or after the date of Royal Assent.

Existing ATO compliance activity relying on existing anti-avoidance provisions – referred to in Taxpayer Alert TA 2015/2: Franked distributions funded by raising capital to release credits to shareholders – can be applied in the interim period.

How will private companies and their shareholders be adversely impacted by Schedule 5?

Building on the comments in the previous section, we are particularly concerned at the potential exposure of *private* companies and their shareholders.

A number of scenarios have been put to us by our members representing private companies, including where:

- As part of a succession plan, a new generation of family members funds and acquires equity in the company, with the funds being applied to pay a franked dividend to the exiting generation of shareholders.
- As part of a mechanism to allow a particular shareholder to exit the company (e.g., due to a falling-out amongst family members, divorce etc), where the departing shareholder is paid a franked dividend funded by a capital raising from those shareholders who remain as shareholders.
- The capital raising is explainable by the changing interest rate environment, whereby equity finance is used to alleviate financing costs associated with a company's debt obligations or address a situation where the company is struggling to obtain debt finance.

Unlike listed companies which actively engaged with Treasury officials during the consultation phase, the voice of those who own Australia's private companies may not have been communicated adequately to Treasury.

CA ANZ and CPA Australia therefore emphasise the importance of the potential impact of Schedule 5 on Australia's private companies – most of whom are small sized companies.

The shareholders of such private companies will be justifiably concerned about a measure which – perhaps years down the track – unexpectedly denies them access to franking credits built up over many years of complying with the tax law in the companies they operate.

CA ANZ and CPA Australia urge the Committee to:

- Obtain data on the franking account balances of Australian private companies (the Form C company tax return obliges companies to report their balances)
- Seek evidence from Treasury and ATO officials on the expected immediate and longer-term impact of Schedule 5 on private companies.

Until the policy rationale and broader implications of Schedule 5 can be properly considered, we ask that the Committee recommend that the Bill be amended such that Schedule 5 is confined to publicly listed companies, and not be applicable to private companies.

Alternatively, the EM should be amended to clarify the treatment of the private companies' scenarios mentioned above and other commonly encountered scenarios raised in other submissions received by the Committee.

ATO officials should also be called by the Committee to outline, in general terms, the circumstances where it has opined (in a public ruling, private ruling or class ruling) that a capital raising/franked distribution arrangement does or does *not* attract the concerns expressed in TA 2015/2. These ATO insights should be incorporated into additional EM examples, or at the very least a Law Companion Ruling (LCR) published contemporaneously with the enactment of the Bill.

Finally, and for private companies only, consideration could be given to inserting a legislative requirement for the ATO to consider whether the franked dividend/capital raising is motivated by "ordinary family or commercial dealings".

Is proposed section 207-159(1) easy to administer and comply with?

Before the proposed section 207-159, the ATO's Taxpayer Alert 2015/2 clearly put taxpayers and their advisers on notice that schemes outlined therein could attract the anti-avoidance rule in section 177EA of the *Income Tax Assessment Act 1936.* Well-advised taxpayers who subsequently sought to fund franked dividends by capital raisings would have responded to this Alert by seeking a binding public, private or class ruling from the ATO in advance of their proposed transactions.

This ATO's administration approach seems to have worked for the large public and multinational business segment, as the ATO's comments in the 2021 Reportable Tax Positions Schedule Findings Report regarding disclosures required for TA 2015/2: states:

> *"**Funding special dividends or buybacks: Question 2 disclosures***
>
> *There were no disclosures at question 2 in 2020–21. Question 2 relates to equity raising to fund special dividend or share buyback arrangements. We are concerned that these arrangements are being used by companies for the purpose of releasing franking credits or streaming dividends to shareholders funded by raising capital. This may result in the release of franking credits that may otherwise have been retained by the company.*
>
> *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."* [Emphasis added]

As such, it is not clear to our members why:

- The ATO's administration approach was seen by Treasury and the Treasurer's office as inadequate, and
- This extremely broad legislative response was required.

Also, many of our members doubt whether the proposed section 207-159(1) improves the situation. Their main concern is that the drafting of the section 207-159(1) is too broad, and that the EM does not provide enough guidance to provide any certainty.

At the very least, it is clear that the ATO will need to publish an extensive LCR. However, based on previous LCR experiences when administering new law, the LCRs often fail to become a "living" document, i.e., they fail to contain additional examples generated by learnings from ruling requests received from taxpayers after the provisions have been enacted. Put simply, many LCRs are seen as "static", unhelpful documents published shortly after enactment and rarely, if ever, updated.

The result is that cautious taxpayers and their representatives will continue to seek binding rulings from the ATO before undertaking capital management activities which may or may not attract proposed section 207-159 – i.e., the situation which currently prevails.

Debt vis-à-vis equity financing

The Committee should also seek evidence from Treasury officials about the impact of proposed section 207-159 on corporate financing decision-making.

It is our view that the potential scope of section 207-159 will add uncertainly to raising equity financing in contrast to debt financing. Interest deductions will generally be available to either a shareholder borrower or the company borrower. Under the so-called "Roberts & Smith financing principle", a company which borrows to pay a dividend (whether franked or not) will often be entitled to a tax deduction for the interest expense: refer paragraph 15 in Taxation Ruling 95/25.

The ramifications where section 207-159 applies

A number of members expressed concern about the ramifications where proposed section 207-159 applies to render a dividend which has already been paid, unfrankable.

They argue (understandably) that the tax system should be designed such that a franked dividend can be paid with *certainty* of tax outcomes – both for:

- the dividend-paying company (the dividend triggers a debit to the company's franking account and the company must comply with franking percentage rules which govern the extent to which dividends can be franked); and
- the recipient shareholder (the dividend triggers a franking tax offset or, for a non-resident shareholder, a withholding tax exemption).

These members point out that it would be impossible for shareholders in a widely held company to self-assess whether section 207-159 applies. The shareholders would rightly rely on the Board and management of the dividend-paying company in complying with the legal obligations associated with paying the dividend.

The thought that section 207-159 could be applied years after the dividend is paid concerned many members, who pointed to the obvious difficulties entailed in:

- revising shareholder distribution statements and explaining why the dividend no longer enjoys franked status; and
- amending shareholder assessments (or paying withholding tax).

The Committee should ask Treasury and ATO officials the following questions:

1. What do they expect section 207-159 will achieve *in practice*; and
2. What will be the *practical impact* of the application of section 207-159 for all stakeholders *after* a franked dividend has been paid?

An ill-disguised attack on dividend imputation?

Committee Members should also note that CA ANZ and CPA Australia have received a number of comments from members who regard proposed section 207-159 as an ill-disguised attack on Australia's dividend imputation system, designed to further curtail the ability of Australian companies to pay franked dividends to shareholders. As evidenced during the 2019 Federal Election campaign, continued access to franked dividends is an important and (for individuals) emotive issue for shareholders – most of whom see franking credits as a pre-payment of income tax on their behalf by the dividend-paying company.

Specific comments on the provisions and EM

- The proposed measure appears to be targeting arrangements involving lower-taxed shareholders (i.e., superannuation funds and charities). If, for example, the scheme involves a resident individual who pays 47% tax (i.e., 17% top-up tax) on the franked dividend, then there should be no relevant mischief in terms of an "early release" of franking credits. The early release has brought forward tax liabilities (rather than a tax refund).

- Similarly, sometimes companies may want to release profits to a holding company (or via a trust to a corporate beneficiary) if the first company's assets are at risk. They may wish to borrow back those funds for use in their business. There is no obvious tax mischief in either case. However, if the loan back to the company is an at-call loan, it may technically be considered an equity interest and now brought within the scope of the rules. This could be addressed by providing an exception for equity interests that are considered at-call loans (i.e., those that meet the requirements in paragraphs 974-75(a), (b) and (c) of the ITAA 1997).

> The Committee should ask Treasury and ATO officials whether the proposed section 207-159 is more likely to be invoked by the ATO where the financing arrangement favours shareholders who enjoy a comparatively low tax rate. If so, the follow-up question should be why existing legislative safeguards (to counter dividend streaming, backed by Part IVA) are considered inadequate. Some of our members have expressed the view that section 207-159 reflects a bureaucratic objective to impose yet another *self-assessed* anti-avoidance provision on taxpayers, thus alleviating the burden on the ATO to identify suspicious arrangements and apply existing anti-avoidance safeguards.
>
> We also recommend an exception for equity interests, that are considered at-call loans under the proposed section 207-159, similar to the exception for certain at call loans under paragraphs 974-75(4)(a), (b) and (c) of the ITAA 1997 (this was an exception until 30 June 2005).

- Our members have raised concerns about the application of the provisions to dividend reinvestment plans. The example in the EM does not provide enough clarity (and certainty) for dividend reinvestment plans (including underwritten dividend reinvestment plans) which are not at the "extreme end". Further, as it appears that all dividend reinvestment plans are prima facie captured by section 207-159, companies cannot argue that section 207-159(1) does not apply as they have an established practice of implementing dividend reinvestment plans. This is because section 207-159(3) prevents a company from relying on a past distribution practice to protect future distributions that fall within section 207-159(1).

CA ANZ and CPA Australia recommend that either section 207-159, or the EM, be amended to provide further clarification for dividend reinvestment plans. For example, another example could be included in the EM that covers an underwritten dividend reinvestment plan where there is a regular dividend payment part of established practice.

- Paragraph 207-159(1)(b) refers to the issue of equity interests in the entity or any other entity (whether before, at, or after the time at which the relevant distribution was made. This paragraph is drafted broadly so that it captures the situation where there is indirect funding of a dividend through having another entity issue equity. Although paragraph 5.26 in the EM states that "[T]ypically in arrangements to which the amendments apply, there will be a significant level of connection between the entities", this is not reflected in the drafting of paragraph 207-159(1)(b), thereby making the provision too broad in application. The lack of guidance around timing also adds to the uncertainty.

CA ANZ and CPA Australia recommend that the comments in the EM about a significant level of connection between the entities be reflected in paragraph 207-159(1)(b). For example, there are many definitions in the ITAA 1997 that define connections and associations between entities – one of these definitions could be used.