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31 MARCH 2023

Dear Chair

Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 – Submissions in response to the Senate Economics Legislation Committee inquiry

Introduction

We refer to the Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 (**Bill**) and the accompanying Explanatory Memorandum (**EM**), which were introduced on 16 February 2023 and later referred for inquiry and report to the Senate Economics Legislation Committee (**Inquiry**).

King & Wood Mallesons welcomes the opportunity to make a submission to the Inquiry into the provisions contained in the Bill.

As a firm, we have acted for many corporations in relation to off-market share buy-backs, capital raisings and the tax implications of distributions and corporate transactions.

We consider that Schedules 4 and 5 of the Bill, in their present form, may have significant consequences for corporations and shareholders.

We refer to our previous submissions to the Treasury on 5 October 2022 (in relation to the exposure draft legislation relating to the proposed measure contained in Schedule 5 of the Bill) that are attached to this submission. We supplement these submissions below.

Executive summary

We welcome the changes made to the proposed provisions in Schedule 5 of the Bill from the exposure draft legislation.

However, we have continuing concerns with the provisions of the Bill in their current form.

In particular:

(a) With respect to Schedule 5 of the Bill, the proposed section 207-159 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) has a broader application that is necessary or appropriate to deal with the perceived mischief. In particular, the proposed measure:

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(i) applies to make a whole distribution unfrankable where equity raised only funds part of the distribution. This creates an inappropriate penalty which is not commensurate with he perceived mischief;

(ii) is broadly drafted and sets a low threshold for activities to potentially trigger the measure. These are more broadly expressed that necessary;

(iii) has a disproportionate effect on entities that do not have a practice of making distributions. This will adversely impact this class of company, many of whom are smaller listed companies;

(iv) creates inappropriate commercial limitations by introducing a bias to not pay dividends outside a periodic dividend policy and creating a difference between funding choices for companies;

(v) has a broader application than Taxpayer Alert 2015/2 (**TA 2015/2**) foreshadowed;

(vi) may substantially increase the need for class rulings that may be conditional on equity being distributed in a certain way, unless proper Australian Tax Office (**ATO**) guidance is provided; and

(vii) has been proposed without clarity as to the mischief being addressed and the need for the measure.

(b) With respect to Schedule 4 of the Bill, we are concerned that proposed provisions amending Division 16K of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**):

(i) go beyond what is necessary to address mischief of the level of streaming of franking credits to particular entities. There are alternative avenues exist to target the mischief sought to be addressed (including changing the ATO's current practice statement on off-market share buy-backs or the introduction of rules which allow them to proceed without significant tax penalties);

(ii) will effectively remove an important way for companies to deal with their share capital, which can be critical to allow for ordinary corporate transactions to proceed; and

(iii) will, if enacted, require further guidance from the ATO clarifying the application of Division 16K of the 1936 Act to on-market share buy-backs and off-market share buy-backs.

Therefore, we submit that:

(a) In relation to Schedule 5 of the Bill:

(i) it should not be legislated in its present from; or

(ii) if it is to be legislated:

(A) its application should be limited to only special dividends;

(B) the assessment of whether the provisions apply should be based on the issue of the equity interest as a whole and the distribution as a whole; and

(C) the provisions should allow for the measure to apply only to the relevant part of a distribution funded by the relevant capital raising activity, as opposed to deeming the whole distribution unfrankable.

(b) In relation to Schedule 4 of the Bill:

(i) it should not be legislated in its present from and should be amended to directly deal with specific aspects of off-market share buy-backs to limit the level of streaming of franking

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credits to particular entities, which may be done without inappropriately penalising public listed companies undertaking off-market share buy-backs; or

(ii) if enacted, the ATO must provide clear guidance about the administration of on-market share buy-backs and off-market share buy-backs by listed public companies.

Schedule 5 of the Bill — Franked distributions funded by capital raisings

Schedule 5 seeks to introduce sections 202-45(ea) and 207-159 into the 1997 Act, which will have the effect of making certain dividend distributions unfrankable if they are partly or wholly funded by capital raisings.

(a) Necessity of measure and mischief addressed is unclear

Clause 5.15 of the EM provides:

> *These amendments are an integrity measure. They prevent entities from manipulating the imputation system to facilitate the inappropriate release of franking credits. They prevent the use of artificial arrangements under which capital is raised to fund the payment of franked distributions (including by way of non-share dividends) to shareholders to enable the accelerated release of franking credits. This addresses concerns raised in Taxpayer Alert TA2015/2 issued by the Commissioner.*

TA 2015/2 raised concerns about arrangements releasing franking credits that may otherwise have been retained by the company. It is not clear that this is a policy underlying the imputation system in the absence of a broader strategy of dividend streaming to avoid wasting franking credits. Further, it is not apparent why raising funds by issuing equity is mischievous but doing so by way of debt is not.

Nonetheless, the prevention of the manipulation of the imputation system through use of artificial arrangements is presently within the coverage of section 177EA of the 1936 Act.

Section 177EA was the anti-avoidance rule specifically raised by the ATO in TA 2015/2. The provision applies to arrangements that have the effect of ensuring that 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. This is a legitimate mischief to be addressed. Preventing the general release of franking credits in the circumstances set out in the Bill is not.

Further, the ATO has observed in its 2021 Reportable Tax Positions Schedule Finding Report that its:

> *risk identification processes and assurance programs have confirmed [that arrangements flagged as being reviewed pursuant to TA 2015/2] are no longer prevalent in the large public and multinational business population.*

Therefore, we consider that Schedule 5 of the Bill should not be legislated.

(b) The whole of a distribution is unfrankable when it is only partly funded by raised equity

Proposed section 207-159 of the 1997 Act presently disaggregates part of the equity interest that wholly or partly funds a distribution when assessing whether the 'principal effect' and 'purpose' tests are satisfied.

Therefore, the effect of the 'principal effect' and 'purpose' tests is that the entirety of a distribution may cease to be frankable where:

(i) part of the franked distribution is funded by equity raised; or

(ii) part of equity raised is utilised to fund a distribution.

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It is unclear why a distribution partly funded from equity raised should render the whole distribution unfrankable. We consider the current wording of section 207-159 of the 1997 Act is disproportionate to the mischief sought to be addressed.

If it should be enacted, we submit that the wording of section 207-159 of the 1997 Act should provide that the assessment of when the measure will apply should be by reference to the issue of equity interests as a whole and the relevant distribution as a whole.

We further submit that in the case that a distribution is funded partly by capital raising activities, the provisions should only apply to render unfrankable the relevant part of the distribution funded by these activities, rather than the whole distribution.

(c) Provisions are broadly drafted and set a low threshold to capture distributions

In addition to our submission above, we submit that the ambiguity around the timing of capital raisings in proposed section 207-159(1)(b), such that the proposed measure may apply to issues of equity interests before, during or after the relevant distribution, is unnecessarily broad.

This subsection effectively provides that a capital raising at any time may jeopardise the ability for a company to make a franked distribution.

The combination of this broad time period, and the application of the proposed measure to any partial funding of distributions through equity raisings, establishes a low threshold for this section to apply to distributions and may render unfrankable distributions beyond the scope of what is being targeted.

This creates an unusual commercial anomaly where a company can undertake a capital raising to pay working capital expenses and retain cash to pay a special dividend but cannot pay a special dividend using retained cash and then raise capital to replenish cash reserves.

We welcome the change to section 207-159(c) requiring both the principal effect and purpose tests to be satisfied. However, we consider that these tests may readily be satisfied where only part of the distribution needs to satisfy these requirements.

(d) Disproportionate effect on companies that do not have a pre-existing distribution policy

Proposed section 207-159(1)(a)(ii) of the 1997 Act provides that a distribution may be captured by the proposed measure where the entity making the distribution does not have a practice of making distributions.

This disproportionately impacts small-to-medium enterprises (**SMEs**), including start-ups and other companies funded by venture capital, that may make dividends after significant initial capital raisings. The capture of these distributions goes beyond the mischief discussed in TA 2015/2.

We submit that the application of this section to SMEs, particularly start-ups, should be reviewed having regard to the objectives identified in TA 2015/2 and the EM.

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(e) Results in inappropriate commercial limitations

For companies that do have a pre-existing periodic dividend policy, we submit that the proposed measure introduces a commercial bias to not pay dividends outside this periodic policy.

This imposes an inappropriate commercial limitation on the flexibility of companies to pay dividends.

Companies may pay dividends at different times to previous years or contrary to previous practice, particularly when unexpected events impact financial markets (as demonstrated by dividend distributions during 2020 and 2021, which were impacted by COVID-19).

Dividends should be payable when sufficient retained earnings exist to pay them, rather than be dictated by a need for conformity with previous dividend distributions. To require companies to do otherwise is inappropriate.

Corporations with large, retained earnings balances may also be prevented from making a franked distribution where investments were recently made from existing cash reserves and additional capital would need to be raised to replenish those cash reserves. This could result in the conduct coming within the scope of the proposed section 207-159 of the 1997 Act. This operates as a further commercial limitation.

(f) Broader application than the intended policy of the measure

Schedule 5 of the Bill seeks to address the concerns identified in TA 2015/2 being where, amongst other things:

- a company with significant franking credits raised new capital from existing or new shareholders (e.g. through a renounceable rights issue);
- at a similar time to the capital raising, the company made a franked distribution to its shareholders in a similar amount to the amount of capital raised (e.g. through a special dividend or an off-market share buy-back); and
- there was a minimal change in the company’s net asset and cash position.

The application of the proposed measure goes beyond the circumstances specified in TA 2015/2 and fundamentally changes the requirements relating to the capital management and dividend distribution practices of companies.

We submit that the scope of distributions addressed in TA 2015/2 could presently be addressed under section 177EA of the 1936 Act.

(g) Commercial uncertainty and administrative burden

The current wording of the proposed sections in Schedule 5 of the Bill risk increasing the number of rulings sought by companies to confirm the treatment of a distribution. This could create an administrative burden on the ATO that may substantially increase the time taken to receive the requested advice. In turn, this may hinder capital market activities.

The fact that equity raisings after a distribution has been made can be relevant when assessing whether the proposed measure applies means that there is a question as to what form of ruling or advice the ATO can provide in respect of a distribution. For example, it is possible that ATO rulings may need to be made on a conditional basis to account for the prospect of a future equity raising.

This raises a number of issues and potentially means any ruling obtained by a taxpayer is of limited utility. We consider this situation needs to be avoided.

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Therefore, given the issues raised above, it is vital for the ATO to be able to provide clear and general public guidance on when these sections may be triggered if they are enacted.

Additionally, the measures will reduce shareholder certainty as to the availability of franking credits, as a later capital raising may result in a dividend becoming unfrankable if the 'principal effect' and 'purpose' tests are satisfied.

(h) Other undesirable commercial impacts

If enacted, this measure will increase the desire for companies to pay less Australian tax, particularly those who have substantial existing franking reserves.

The imputation system provides an incentive for companies to not seek to minimise Australian tax paid because such tax paid can be distributed to shareholders. Where the capacity to frank a dividend becomes ambiguous, this incentive is reduced.

The certainty for a company to be able to provide fully franked dividends reduces the cost of capital by reducing the incentive to undertake debt financing. If enacted, Schedule 5 of the Bill risks increasing the cost of capital as debt raisings become more attractive.

It is unclear why the sections proposed in Schedule 5 of the Bill apply to raising equity but not increasing debt. This introduces an inappropriate commercial limitation.

Increased levels of debt will also result in greater debt leveraging and inherent risk. This is particularly the case in light of the proposed amendments to the thin capitalisation provisions recently released in exposure draft legislation form.

(i) Concluding remarks

We submit that due to these issues, the most appropriate outcome is for Schedule 5 of the Bill to not be legislated.

If Schedule 5 of the Bill is enacted, its scope should be limited to apply to the transactions initially referred to in TA 2015/2. Most importantly, in applying the 'principal effect' and 'purpose' tests, the assessment of whether the provisions apply should be based on the issue of the equity interest as a whole and the distribution as a whole.

ATO guidance that clearly states when a distribution will fall under the scope of the sections will also be important if Schedule 5 is enacted.

Schedule 4 of the Bill — Off-market share buy-backs

Schedule 4 of the Bill seeks to broadly align the income tax treatment of off-market share buy-backs undertaken by listed public companies with on-market share buy-backs.

We consider that these provisions go beyond what is necessary to prevent the mischief sought to be addressed.

In the case they are enacted, it is critical that revised ATO guidance is provided addressing the issues relating to the administration of on-market share buy-backs and off-market share buy-backs by listed public companies.

(a) Provisions go beyond what is necessary to prevent the streaming of franking credits

Off-market share buy-backs are an important capital return mechanism. This mechanism supports listed public companies in undertaking appropriate corporate transactions.

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There are alternative avenues exist to target the mischief sought to be addressed (including changing the ATO's current practice statement on off-market share buy-backs or the introduction of rules which allow them to proceed without significant tax penalties).

The mischief sought to be addressed is the inappropriate streaming of franking credits by listed companies to shareholders through off-market share buy-backs that return capital at a discount. We consider that this mischief can be addressed without causing wastage of franking credits through the penalty regime that would effectively be implemented if Schedule 4 of the Bill was enacted.

The manner in which off-market buy-backs can be undertaken by a listed public company is already heavily regulated by several ATO administrative decisions and processes, including Practice Statement Law Administration PS LA 2007/9 (**PSLA 2007/9**). This practice statement addresses the treatment of several aspects of these off-market share buy-backs and the associated operation of Division 16K of the 1936 Act.

We propose that the streaming of franking credits can be better addressed by changing certain aspects of PSLA 2007/9 without imposing an effective penalty on listed public companies undertaking an off-market share buy-back. This includes:

(i) *Increasing flexibility of the maximum discount*

PSLA 2007/9 provides that section 177EA of the 1936 Act is capable of application to off-market share buy-backs if the maximum discount from the market value of the shares exceeds 14%. It is more likely that there will be an effective streaming of franking credits to taxpayers who can take advantage of those credits where the level of discount from the market value of the securities is lower. If this arbitrary amount is adjustable, it would allow for a different split between the capital and dividend amounts of a buy-back.

(ii) *Amending the operation of the 'at risk' rules*

The 'at risk' period could be extended to prevent participants from acquiring shares after a buy-back announcement. There currently exists a 3-4 day period where a participant can acquire shares and participate in the buy-back which satisfies the at risk rules.

(b) Need for ATO Guidance

The proposed amendments to Division 16K applicable to listed public companies undertaking off-market share buy-backs risk creating anomalies when companies undertake on-market share buy-backs.

This is on the basis that there is a risk that the change in the tax treatment of off-market share buy-backs to align with the tax treatment of on-market share buy-backs may have a corollary effect of impacting the ATO's administration of on-market share buy-backs (to that which the ATO has applied to off-market share buy-backs).

There presently exists a significant risk that the alteration of the off-market share buy-back rules may inadvertently force some or all of the purchase price of an on-market share buy-back to be sourced from profits.

Again, this is on the basis that the current administration by the ATO appears to be to allow on-market share buy-backs to be funded from share capital. This is in contrast to the existing ATO guidance on off-market share buy-backs, where there are specific rules to determine the extent to which the buy-back price must be sourced from share capital or profits.

If Schedule 4 is enacted, the ATO must issue clear and revised guidance addressing issues relating to the administration of on-market share buy-backs and off-market share buy-backs by listed public

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companies. It is important that these rules do not introduce an inappropriate penalty through franking credit wastage.

(c) Concluding remarks

Off-market share buy-backs are an important capital reduction mechanism and franking credits have considerable value to shareholders. It is preferable that the legislature seeks to address the perceived mischief of the inappropriate streaming of franking credits without forcing all off-market share buy-backs to be treated in the same way as on-market share buy-backs.

It is preferable to address this mischief by changing aspects of PSLA 2007/9 and allowing off-market share buy-backs to proceed without introducing an effective tax penalty and franking credit wastage.

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 Senate Standing Committees on Economics.

- Darren McClafferty, Managing Partner, Clients, [redacted];
- Tim Sherman, Partner, [redacted];
- Andrew Clements, Senior Consultant, [redacted]; and
- Jason Barnes, Special Counsel, [redacted]

Yours faithfully

[redacted]

King & Wood Mallesons

Attachment: KWM Submission Dated 5 October 2022

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5 OCTOBER 2022

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

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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:

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(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

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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.

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(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

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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.

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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

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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.

If there are any queries arising from these submissions, please contact:

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Yours faithfully

King & Wood Mallesons