The Tax Institute

16 February 2024

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Australian Taxation Office

By email: Virginia.Gogan@ato.gov.au

Dear Ms Gogan,

Capital raised for the purpose of funding franked distributions

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to its consultation paper titled 'Capital raised for the purpose of funding franked distributions' (**Consultation Paper**).

In the preparation of this submission, we have consulted with members of our National Large Business and International Technical Committee and National Small and Medium Enterprises Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The Consultation Paper concerns the application of a new integrity provision in section 207-159 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**). The new integrity provision was introduced by the *Treasury Laws Amendment (2023 Measures No.1) Act 2023*, and supported by the accompanying explanatory memorandum (**EM**) and supplementary explanatory memorandum (**supplementary EM**).

The new integrity provision raises concerns regarding the scope and proper application of section 207-109 of the ITAA 1997. The Tax Institute is of the view that these concerns require guidance from the ATO to ensure that rules operate as intended, while also providing certainty to arrangements that are not within its scope, or the scope of ATO Taxpayer Alert TA 2015/2: *Franked distributions funded by raising capital to release franking credits to shareholders* (**TA 2015/2**).

We consider that there are several key areas that require guidance, including the Commissioner's views on the application of section 207-159 to:

- private groups with minimal or no distribution history;
- dividend reinvest plans (**DRPs**);
- transactions concerning mergers and acquisitions (**M&A**) between unrelated parties;

- family or commercial dealings of a private group;
- capital raised for general purposes; and
- employee share schemes.

We also consider that there are concepts contained in section 207-159 that require detailed guidance and explanation from the Commissioner to ensure that taxpayers understand their obligations and are able to effectively plan their commercial decisions. These include:

- what constitutes a 'substantial part' of the distribution;
- what constitutes a normal commercial practice in the context of a DRP; and
- other relevant considerations that will be taken into account when the Commissioner is considering the application of paragraphs 207-159(2)(f) and 207-159(4)(k).

Further details are contained in **Appendix A**.

We note that our submission is intended to be a starting point for further conversation and consultation. We consider it important to ensure there is ongoing dialogue between the ATO and the tax profession in relation to areas of guidance that are needed under the new integrity measure. To this end, we would be pleased to continue to work with the ATO in the further development of future guidance and would like to arrange a time for a discussion. Please contact our Senior Counsel – Tax & Legal, Julie Abdalla, on (02) 8223 0058 to arrange a time to workshop the issues further, or to discuss any aspect of our submission.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

Yours faithfully,

Scott Treatt
Chief Executive Officer

Todd Want
President

APPENDIX A

We have set out below our detailed comments and observations for your consideration. Our submission broadly follows the Consultation Paper. All references are to the ITAA 1997 unless otherwise indicated.

Consistency of distributions with an established practice

Established practice for private groups

The established practice requirements will be difficult for private groups that do not have a regular distribution history, or have no distribution history, to demonstrate. It is common for private groups to only make periodic distributions. Further, the record keeping systems used by private groups are unlikely to be designed in a manner that regularly prepares and produces the same level of financial detail that is required for public companies.

The Tax Institute is of the view that the ATO should provide detailed guidance supported by examples of when a private company might be considered to have a pattern of distributions that might be considered regular practice, what distributions might be made in accordance with that practice, and what records might assist in determining an established practice. That is, given a private company may only pay dividends on an ad-hoc basis (if at all), how does the ATO propose to administer subparagraph 207-159(1)(a)(ii)? It would also be helpful if the ATO could provide guidance on, or examples of, any distribution practice or practices that may be of concern in relation to private companies.

Dividend reinvestment plans

We consider that there are several aspects of the new integrity measure's interaction with DRPs that requires clarification and further guidance. These are discussed in further detail below.

Normal commercial practices

Paragraphs 5.45A of the EM and 4.8 of the Supplementary EM state that:

> 'Further, dividend reinvestment plans, including underwritten dividend reinvestment plans, undertaken for **normal commercial purposes** are not intended to be affected by the operation of the measure.'
>
> [emphasis added]

We consider that the use of the phrase 'normal commercial purposes' is vague and should be explained in ATO guidance. This is necessary to ensure that taxpayers and tax practitioners can understand the nature of arrangements they are able, or unable, to undertake, without risk of the new integrity rule applying. Most taxpayers are likely to enter DRPs for commercial reasons. Clear articulation of aspects that are, in the Commissioner's view, uncommercial, will better guide and inform their decisions.

We also consider that examples of common DRP arrangements used by public and private companies should be provided in the proposed guidance. Examples should be detailed and highlight the specific features that distinguish them as commercial or uncommercial.

Application to dividend reinvestment plans

TA 2015/2 stated that the underlying mischief was not directed towards DRPs that operated for ordinary dividends, stating:

> 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**).
>
> [emphasis added]

This view is supported by paragraph 5.45A of the EM (extracted above), and the original announcement for the new integrity measure in the Mid-Year Economic and Fiscal Outlook 2016–17 (the **MYEFO announcement**) which stated:

> **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.
>
> [emphasis added]

As a result, we consider that the proposed guidance products should confirm that DRPs undertaken for ordinary dividends (whether underwritten or not, and regardless of how often DRPs have been previously underwritten) should not be subject to the new integrity provision.

Past practice of dividend reinvestment plans

Broadly, subsection 207-159(3) states that in determining whether a distribution is, in effect, an ordinary distribution, prior franked distributions that would otherwise have been caught by section 207-159 but for the ordinary distribution exclusion are excluded. In effect, section 207-159 is required to be applied to prior dividends on a notional basis.

Paragraphs 5.20 and 5.21 of the EM state:

> Any practice involving the sort of mischief the amendments seek to prevent does not protect future distributions even if the practice existed prior to the date of application of these amendments. This is achieved by providing that the past distribution practice of an entity cannot be established from a franked distribution or a distribution that would be franked made either before, on or after 15 September 2022 if these amendments would apply to treat it as unfrankable.
>
> **Broadly, this requirement ensures that this integrity rule does not affect ordinary established distributions that have been made on a regular basis and are not made as part of artificial arrangements designed to accelerate the distribution of franking credits to shareholders.**
>
> [emphasis added]

We consider that the ATO should provide practical guidance on how this provision will be applied. We note that arrangements consistent with what is described in TA 2015/2 should be caught by section 207-159.

However, where a company had DRPs in place *prior* to 15 September 2022 for its ordinary dividends, we are of the view that the ATO should confirm that subsection 207-159(3) is not engaged to otherwise cause future DRPs for ordinary dividends to be caught. That is, a previously underwritten DRP for an ordinary dividend should not be disregarded under subsection 207-159(3) if it is assumed that it was instead a special dividend. This approach should be maintained regardless of whether an APRA or ASIC requirement applies.[1] This approach will ensure that every company entering into a DRP will not be required to consider the principal effect and purpose test in paragraph 207-159(1)(c), and in the case of a public company, have to engage with the ATO each time.

Principal effect and purpose of issuing equity interests

Substantial part of the distribution

Broadly, paragraph 207-159(1)(c) requires that the principal effect and purpose of a 'substantial part' of the relevant distribution was to be funded by the issue of equity. The Tax Institute is of the view that detailed guidance, with supporting examples, is required on the Commissioner's view of what constitutes a 'substantial part.' Without this guidance, taxpayers and tax practitioners will be left without any indication of this new threshold in these integrity provisions. In our view, guidance on this aspect is important in any product issued by the ATO regarding the new integrity measure.

Mergers and acquisitions

We consider that a number of practical issues arise when applying the principal effect and purpose tests to a change of control transaction (such as a takeover or a scheme of arrangement) in both a public and private context. These issues can also apply to any special dividends.

Feedback from our members indicates that the payment of a pre-sale dividend is common practice in Australian merger and acquisition (**M&A**) transactions. At least 8 Class Rulings have been issued in both 2022 and 2023 for public M&A transactions alone.

In ascertaining the principal effect and purpose tests, we consider there to be two primary categories of issues. These are discussed in below.

Equity interests issued before or after special dividend

Section 207-159 can apply where an equity interest is issued either before or after the special dividend has been paid. Generally, the decision to pay a pre-sale dividend is made by the board of directors of the target company. The directors will often have knowledge of what equity interests have been issued by the target company before or at the time of the dividend. However, they are unlikely to have knowledge, or control, of any issue of equity interests that occur after the takeover completes or the special dividend is paid. To do this, the target company will likely need an understanding of the purchaser's funding structure in relation to the target, including how any existing debt of the target group is to be refinanced.

Accordingly, we consider that the Commissioner should provide his views on:

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[1] See paragraph 207-159(1)(d).

- how a board of directors of a target company should obtain comfort regarding how the 'after the time' limb of paragraph 207-159(1)(b) applies; and
- how the ATO will provide rulings/certainty to taxpayers where the potential application of section 207-159 depends on a future action.

We consider that this issue can arise for any special dividend paid by a company. In these instances, taxpayers would benefit from guidance regarding what steps are required to be taken to ensure that:

- a future issue of equity interests by the company does not effectively cause section 207-159 to retrospectively apply to a special dividend; or
- a prior issue of equity interests, does not cause section 207-159 to apply to the special dividend.

For a public company, it should be sufficient if, at the time the special dividend was paid, there was no intention that would otherwise be required to be disclosed to ASX or as part of the takeover documents that an equity raising would be required to fund the special dividend. Likewise, if any prior issue of equity interests was disclosed as being for a reason other than payment of a special dividend, then there should not be a need to consider any prior equity issuances. For a private company in an M&A context, it should be sufficient that an undertaking on the purchase be included in any relevant takeover documents as to what occurs after the takeover completes/the special dividend is paid.

Equity interests issued by other entities

We consider that there are a number of instances where it is uncertain whether section 207-159 will apply in the context of equity interest being issued by other entities.

> **Example 1 – funding special dividend by way of loan**
>
> Company A (an unrelated third party to Target Company) has surplus cash of $100.
>
> Company A provides $100 to Company B, a wholly-owned subsidiary and a member of the A Co tax consolidated group, in exchange for the issue of equity interests by Company B.
>
> Company B then lends the funds to Target Company which pays a special dividend of $100.

In Example 1, the Target Company has funded the special dividend by way of a loan from Company B. In practice, the directors of the Target Company will not necessarily know:

- how Company B or Company A obtained the funds; or
- that Company B issued shares to Company A.

We note that no equity has been issued that, of itself, funded the special dividend as Company A already had surplus cash. As a result, we consider that this is not a scenario where section 207-159 should apply on the basis that the principal effect and purpose tests are likely not satisfied. We consider that the Commissioner should provide his views and rationale regarding this scenario.

> **Example 2 – equity interest to fund purchase of asset**
>
> Company A sells an asset to Company B for $100. Company B is unrelated to Company A.
>
> Company A uses the proceeds to pay a special dividend to its shareholders.

Company B issues equity interest to its shareholders to fund the purchase of the asset from Company A.

Similar to Example 1 above, we consider that section 207-159 should not apply as the principal effect and purpose tests are not satisfied. We consider that the Commissioner should also provide his views on the potential application of section 207-159 in this circumstance.

We also consider that the Commissioner should include as part of his views:

- the type of scenarios where the issue of an equity interest by an entity other than the company paying the dividend (the Target Company in this case) can be caught by the provisions; and
- what level of inquiry is required to be undertaken by the Target Company.

Feedback from our members indicates that this issue can arise outside of an M&A context in instances where a company borrows from an unrelated third party to fund a special dividend. We consider that the Commissioner should provide his views in this variation where the only issue of equity interests is within a tax consolidated group, and those funds are provided by way of a loan to a third party that then pays the special dividend. That is, where no third-party equity interests are issued.

Example 3 – Sale of assets to unrelated party

Company A has sold assets to Company B, that is unrelated third-party vendor, in return for equity in Company B. There are several commercial drivers for this transaction including potential financing challenges for the purchaser.

Company A then makes an *in specie* distribution (by way of dividend) of the shares received from the purchaser and that distribution is franked.

As a further variation of Example 2 above, we consider that the Commissioner should provide his views on whether section 207-159 would apply to Example 3.

Family or commercial dealings of private companies

The Tax Institute is of the view that ATO guidance should be provided regarding the Commissioner's view on what constitutes 'family or commercial dealings of private groups' that are not intended to be captured within the scope of section 207-159. Paragraphs 5.45B of the EM and 4.8 of the supplementary EM note two succession planning examples that are not intended to be caught. We consider that detailed examples of these scenarios should be included in ATO guidance.

We also consider that other 'family or commercial' arrangements that the Commissioner is of the view should not be caught should also be included in the proposed guidance.

Proportion of the distribution funded by capital raising

Relevant part

We understand that amendments to subsection 207-159(1) regarding the 'relevant part' were introduced to ensure that:

- the measure only applies where a substantial part of the distribution was equity funded; and

- where the measure does apply, the unfrankable component is determined on a proportionate basis.

We consider that the ATO should confirm that the references to 'relevant part' in subsection 207-159(1) and paragraph 207-159(1)(c) achieve this outcome.

Capital raised for general purposes

Feedback from our members indicates that companies can sometimes undertake capital raisings for 'general purposes.' In these instances, the cash from the capital raising is usually put into the same bank account as cash from the ordinary business operations of the company.

Under the proportionate approach in subsection 207-159(1), it appears that a detailed tracing of the funds received from these capital raisings might be required to ensure that the company can evidence that the cash from the capital raising has not funded a distribution. If this is correct, this approach will require impacted taxpayers to incur significant expense to undertake this difficult tracing activity. We are of the view that this outcome is not the optimal way (from a commercial and value perspective) for a company to manage their limited resources and recommend that the Commissioner consider alternative approaches that do not impede effective cash management strategies.

Other feedback

Other relevant considerations

The new integrity provision does not reference a threshold requiring the arrangement to be 'artificial' or undertaken for the purposes of 'manipulating the inappropriate release of franking credit.' Accordingly, we consider that detailed guidance should be provided regarding the Commissioner's view on the factors that constitute a 'relevant consideration' for the purpose of paragraphs 207-159(2)(f) and 207-159(4)(k). In doing so, we consider it important to ensure that the measure is appropriately targeted to arrangements of concern as identified in TA 2015/2, and other similar arrangements. It would not be an appropriate outcome for this measure to inadvertently target low-risk or otherwise commercial arrangements.

Employee share trusts

The use of employee share trusts (**EST**) is a common structure in corporate Australia to facilitate the operation of employee share schemes (**ESS**). Broadly, an EST will acquire shares to facilitate the operation of an ESS through either:

- acquiring shares on-market; or
- subscribing for shares (i.e. an issue of equity interests) in the company.

In respect of a subscription for shares, we consider that the ATO should confirm that the issue of shares to an EST in a manner that satisfies the sole activities test in subsection 130-85(4) in and of itself, does not cause section 207-159 to apply to any dividend paid by the company before or after the payment of a special dividend. If the ATO is of the view that it does, we consider that a detailed explanation of the Commissioner's underlying rationale should be included.

Consequential merger and acquisition amendments

We consider that the Commissioner should make consequential amendments to other guidance relating to M&A following the introduction of the new integrity provision, including:

- updating the acceptable timetables for the 45-day rule for a pre-sale dividend; and
- clarifying where a pre-sale dividend does, and does not, form part of the capital proceeds for the CGT event.

Entity issuing equity interests

Paragraph 207-159(1)(b) applies to an 'equity interest', which is defined by subsection 995-1(1) to include the interests issued by trusts and partnerships as defined in section 820-930. However, section 820-930 only extends the definition of an equity interest for a trust or partnership for the purpose of the thin capitalisation rules and the taxation of financial arrangements (**TOFA**) provisions in Division 230. Therefore, the issue of an equity interest by a trust or a partnership does not appear to be covered by paragraph 207-159(1)(b). Despite this, paragraph 5.26 of the EM states that:

> The entity issuing the equity interests does not need to be a company for income tax purposes.

The EM appears to be incorrect regarding the operation of the law, potentially including commentary from the earlier exposure draft of the integrity which sought to further extend the definition in section 820-930 to section 207-159. As a result, we consider that further guidance is needed regarding whether the issue of an equity interest by a trust of partnership enlivens the operation of section 207-159. If the Commissioner is of the view that it can, we consider that proposed guidance should also include a detailed explanation of the Commissioner's rationale.