BDO

Tel: +61 2 9251 4100
Fax: +61 2 9240 9821
www.bdo.com.au

Level 11, 1 Margaret St
Sydney NSW 2000
Australia

By email: frankeddistconsult@treasury.gov.au

5 October 2022

Director
Corporate Tax Policy Unit
Treasury
Langton Cres
Parkes ACT 2600

Dear Madam/Sir,

FRANKED DISTRIBUTIONS AND CAPITAL RAISING - BDO SUBMISSION

BDO refers to the invitation by Treasury to provide comments on the Government's **Exposure Draft - Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings (Exposure Draft legislation).**

BDO is pleased to provide comments on the Exposure Draft legislation in relation to franked distributions funded by capital raisings. In summary, our main concerns are that the Exposure Draft legislation is drafted very widely to prevent very specific inappropriate arrangements. It will apply to a broad range of taxpayers including shareholders that had no control over or involvement in the purported mischief.

Neither the exposure draft legislation nor the explanatory memorandum provide a good policy explanation as to why the funding of franked dividends via capital raising is inappropriate from a policy perspective.

Further, because of the long lead time between the 2016-17 MYEFO announcement of the proposed changes and release of exposure draft legislation, the retrospective application of the changes is inappropriate. It is not appropriate that companies should be left without clear guidance on the specific provisions for so many years. During the long period between the previous Government's announcement and the confirmation these rules will eventually become law, many companies have undertaken capital raisings and made franked distributions that are likely to fall into these proposed measures.

BDO's detailed comments in this regard are in the attached appendix.

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Should you have any questions, or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Technical Leader

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Appendix

BDO Submission to Treasury
Exposure Draft - Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings

BDO has considered the Exposure Draft - Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Franked distributions funded by capital raisings (Exposure Draft legislation) which sets out the Government's proposed integrity measures to retrospectively prevent companies from attaching franking credits to dividend distributions that are funded by capital raising activities which result in the issue of new equity interests. We provide the following comments on the issues of concern in the Draft legislation.

1. **Why are franked distributions funded by capital raisings considered an 'inappropriate access of franking credits'?**

   BDO submits that there is not an adequate explanation of why the Treasury considers the practice of funding franked dividends out of capital raising are "arrangements set up to inappropriately access franking credits that were not intended under the imputation system". The only indication of the object of identifying what are frankable and unfrankable distributions is, in s202-35 of ITAA 1997, which says the object of the provisions "is to ensure that only distributions equivalent to realised taxed profits can be franked". This merely requires the company to show that the franked dividends it has made are equivalent to realised taxed profits. There is no indication in the imputation provisions that it requires a direct tracing of the funds used to pay the dividends back to the funds received that contributed to the profits.

   The franking account ensures franked dividends are 'equivalent to taxed realised profits'

   The current imputation regime ensures the franked distributions are equivalent to realised taxed profits by the appropriate recording of company tax paid via the company's franking account and the subsequent reduction of the franking account balance when franked dividends are paid. This ensures the franked dividends paid are equivalent to the taxed realised profits of the company that have not been already distributed. There is no indication why the funding of the payment of the franked dividend out of capital raising is inappropriate in this context.

   The proposed changes will inappropriately affect the commercial funding decisions

   BDO understands that it is necessary to prevent entities that make franked distributions from manipulating the imputation system to obtain inappropriate access to franking credits. However, we would question why the Government is targeting the raising of equity capital to fund the payment of franked distributions by deeming them as unfrankable; whereas, using debt to raise funds for the same purpose would potentially produce the same outcome of distributing excess retained profits but would not result in an unfrankable distribution. By introducing rules which distinguish the choice of funding methods based on income tax considerations and attaching severe tax consequences to raising equity capital, the Government is effectively dictating the choice of funding for businesses.

   Punishing companies that reinvest profits in the business

   The exposure draft legislation would act a deterrent to companies reinvesting its profits into its business. It is common for successful companies with cash attributable to realised taxed profits to reinvest cash in the business, with the aim of producing additional profits, on which income tax

would be paid. However, there is pressure on listed and other widely held corporates to pay franked dividends to shareholders. The raising of equity to fund the payment of franked dividends is a good commercial solution for resolving this dilemma. The effect of exposure draft legislation would be for these corporates to either not reinvest the profits in the business or fund the dividend payments via debt. It is BDO's view that neither of these options is a preferable policy position compared to the funding of the dividends via equity capital.

The provisions are too widely drafted

There is also a concern that, as the exposure draft legislation is drafted so widely, any dividend prior to or after arrangements to raise capital could be caught by these rules even where the purpose of the capital raising is not to access 'trapped' franking credits.

This outcome would be produced by the 'principal effect' clause in subsection 207-159(1)(c)(i), which says:

> "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;"

We submit that this clause has too wide application and should be removed from the amending legislation if it is to proceed..

Reconsider policy intent of proposes changes

We would request that before the Exposure Draft legislation is introduced, the Government should clarify the policy intent underpinning the proposed measures and reconsider measures in the Exposure Draft legislation that deter companies from raising equity capital. It is BDO's view that there is no good policy reason for the introduction of these proposed new rules. We request that the Government reconsider these proposed rules which would have the effect of dictating the choice of funding for businesses and thus skew economic outcomes.

2. **Reconsider retrospective application of Exposure Draft legislation**

When the Exposure Draft legislation giving effect to the proposed amendments becomes law, it will apply to dividend distributions made on or after 19 December 2016 (the date when the measure was first announced by the previous Government in the *2016-17 Mid-Year economic and Fiscal Outlook (MYEFO 2016-17)*). We acknowledge the Government's concern in the EM that the amendment should be retrospective because:

> ***'….it is necessary because the measures prevent artificial and contrived arrangements set up to inappropriately access franking credits that were not intended under the imputation system. Allowing such activity to continue between announcement and the passage of legislation without any consequences under the law would encourage their use during this period.***

However, given the long period between announcement and the release of the exposure draft legislation, the amendment has clearly not been a priority of Government, despite Treasury's disingenuous claims in the Explanatory Memorandum (EM) above.

We consider that the extent of the retrospective application of the announcement in MYEFO 2016-17 is not justified given that the announcement did not contain sufficient detail to allow potentially affected taxpayers to identify that they would be at risk and the almost six years it has taken to provide the details that are now contained in the exposure draft legislation.

We would request that before the Exposure Draft legislation is introduced, Treasury reconsider retrospective application of the amendments and apply more moderate approach to the start date of the proposed draft legislation.

Effect on Mum and Dad shareholders

BDO is concerned the retrospectivity back dated to 19 December 2016 is an extreme measure that will unfairly affect large numbers of 'mums and dads' who are shareholders that rely on franked dividend income. It is likely that many of these and other shareholders would have received fully franked special dividends from major ASX listed and other companies over the past six years. The shareholders, through no fault of their own, would have claimed franking credits attached to franked distributions that were funded by capital raising activities. If the proposed measures apply retrospectively, such shareholders will be denied franking credits that were received over the past six years. This will result in shareholders having to reverse franking credits claimed since December 2016, repay refunds of excess franking credits or pay/increase payment of income tax on the special dividends without any concessions for potential interest and penalties.

Impertinent to Parliamentary processes

Furthermore, introducing tax laws by announcement which are back dated to December 2016 is impertinent to the process of passing laws in Parliament, which generally requires the swift introduction of draft legislation to Parliament after the announcement of the proposed change. Six years gap between the announcement and the release of exposure draft legislation is one of the longest periods between announcement of the proposal and the release of draft legislation. In previous cases where there has been an extended period between announcement and release of draft legislation the Government has generally provided some comment indicating the proposal is still being proposed or reconsidered. This is not what has happened in this case. In the case of the proposal in the exposure draft legislation there has been virtually no comment from any of the Governments between the date of the announcement on 19 December 2016 and the date the exposure draft legislation was released on 14 September 2022.

Uncertainty for taxpayers and increasing the ATO workload

The announcement of proposed retrospective legislation has caused uncertainty for taxpayers and posed a dilemma for affected taxpayers as to whether they should follow the existing law or anticipate the proposed change when preparing tax returns. From the ATO's viewpoint, a proposed law change would increase many taxpayers' liabilities, increasing the ATO's workload to process all the required amendment assessments and a significant number of shareholders will receive unexpected amended assessments to repay refunds or to increase their tax liability.

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3. **MYEFO 2016-17 announcement did not give sufficient details of affected distributions**

In the MYEFO 2016-17, the Government stated it would:

'…. introduce a specific measure preventing the distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities.

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

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

This measure will address the issues raised by the Australian Taxation Office in Taxpayer Alert TA 2015/2: Franked distributions funded by raising capital to release credits to shareholders.

This measure will apply to distributions made after 12:00pm (AEDT) on 19 December 2016. It is estimated to have a gain to revenue of $30.0 million over the forward estimates period.'

While the exposure draft legislation gives specific details of the types of distributions or the types of capital contributions affected by these proposed new rules, this level of detail was not provided in the previous Government's announcement on 19 December 2016 as evidenced from the extract from the announcement above. This made it very difficult for companies to determine whether a particular type of capital raising would be affected by the previous Government's announcement. Capital raising and payment of dividends by companies is a very common occurrence and given the lack of detail in the MYEFO 2016-17 announcement and the long time it has taken to release the exposure draft legislation it is inappropriate to expect companies to change their dividend and capital raising activities without knowing the level of detail of the proposed rule that has subsequently been released in the exposure draft legislation.

4. **Reconsider targeted taxpayers and affected shareholders**

The shareholders in the affected companies will have to repay to the ATO the amount of the franking tax offsets they received on the affected distributions even though most of them had no involvement in capital raising and decision to pay a special dividend. Many of these shareholders will be retirees, their superannuation funds and other low income individuals who may find it difficult to make these payments back to the ATO. The processing of the amounts of amendments required by the ATO would also present a challenge for the ATO, all of which would have to be done within 12 months of the date of royal assent of the amending legislation.

BDO is concerned that the Exposure Draft legislation is drafted very widely and therefore will apply broadly to range of taxpayers including ASX listed companies, private companies both paying and receiving dividend distributions as well as hundreds of thousands of shareholders who have received distributions including individuals, trustee or beneficiaries of trust, companies, large institutional superannuation funds etc since 19 December 2016. All resident shareholders that directly or indirectly receive dividend distributions affected by these proposed changes will have to repay the franking credit offsets that have retrospectively been denied by these proposed new rules.

Dividend paying companies will also have to consider their withholding tax obligations on dividends to non-resident shareholders, with no prospect of recovering that withholding tax from the shareholders who should bear the tax as outlined below.

Blameless shareholders will suffer the brunt of the changes

Shareholders that have not breached any tax laws will be severely affected and punished for the actions of the companies making dividend distributions funded by capital raising activities. The shareholders will be the ones pursued by the ATO and will ultimately bear the tax consequences of these amendments as outlined above. This seems unfair for shareholders that had no hand in determining the source of the dividend distributions and 'inappropriately accessed franking credits'.

Further to challenge any amended assessment issued by the ATO, these blameless shareholders, will only be able to justify such a challenge if they can get access to the company's intentions and records as payer of the dividends, this will be very difficult. This has the possibility of causing a multitude of legal actions being taken by the shareholders against the companies and the companies' directors.

Difficulty for companies in recovering withholding tax from non-resident

The proposed amendments will also impact companies making distributions of franked dividends to non-resident shareholders over the past 6 years which were exempt from dividend withholding tax under s 128B(3)(ga) will now be retrospectively treated as unfranked dividends and will not be exempt from withholding tax. This means the companies that paid those dividends must subsequently attempt to collect the withholding tax of 30% (or relevant DTA rate) on dividends paid to non-resident shareholders dividends over the past 6 years, which is likely to be very difficult.

Therefore, we would request that before the Exposure Draft legislation is introduced, the retrospective introduction of these rules is reconsidered. If this is not possible the Government should at least consider as a minimum, the retrospective provisions should only apply to shareholders with a level of influence over the director's decisions (e.g. greater than 20% shareholding, but only if no one else actually controls the company). Alternatively if retrospective application is inevitable, the retrospective action should only be targeted at the company that has raised capital, and not the payee, shareholder.

5. The extent of the distribution that is funded from the equity raising.

The exposure draft legislation is drafted in such a manner that it is not clear to what extent the distributions have to be attributed to the issue of equity interests. While subsection 207-159 (2)(c) in combination with subsection 207-159(4)(b) indicates the extent that the funds from the equity

interest differs from the amount of the relevant dividends is to be taken into account, it does not give any indication for what the level of this difference is determinative in this consideration i.e. in other words is it 50% or 80% etc. Nor does it indicate whether once this determination is made, is the whole of the distribution to be unfranked or is it only the part of the distribution that was funded by the equity raising that is unfranked. These uncertainties need to be better explained in the legislation or at least guidance given in the Explanatory Memorandum.

Conclusion

BDO submits that the Government should resolve and clarify many of the issues and problems contained in the Exposure Draft legislation that are highlighted in our submission…...