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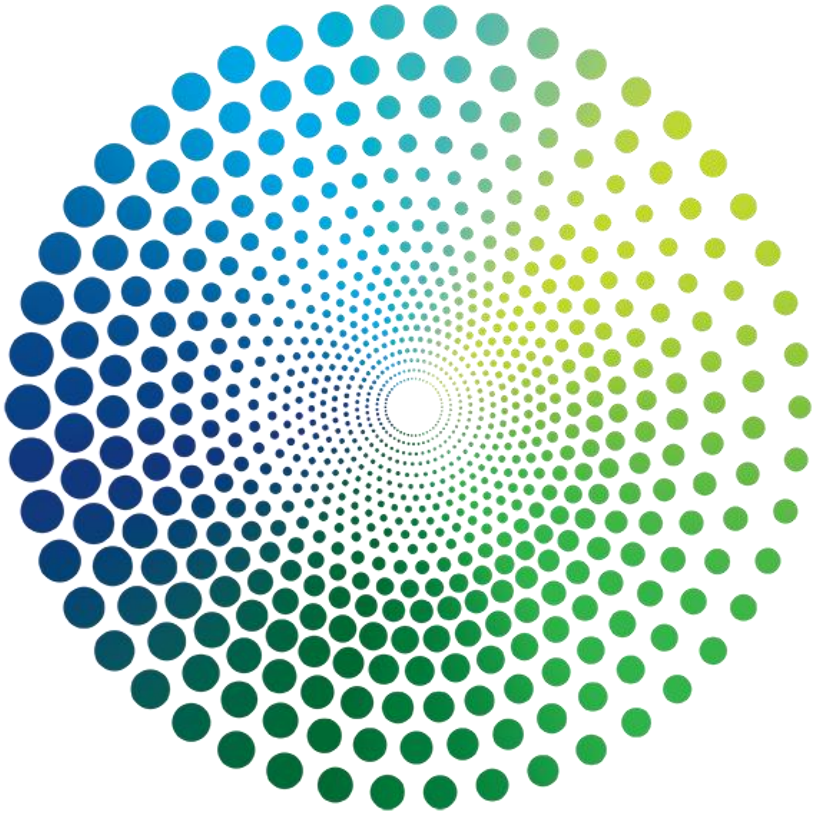

Tax Insights

Franked distributions & capital raisings

Franking, sledgehammers, peanuts and uncertainty

Snapshot

The Government introduced [Treasury Laws Amendment (2023 Measures No. 1) Bill 2023] (the Bill) on 16 February 2023 which deals with, inter alia, off-market share buy-backs and franked distributions funded by capital raisings.

This Tax Insights addresses the measure relating to **franked distributions and capital raisings**. Where the measure applies to post 15 September 2022 distributions, the relevant distribution will be **unfrankable**, which will result in higher than expected tax liabilities in the hands of the shareholders. An unfrankable dividend does not result in a tax offset for resident shareholders, will be subject to dividend withholding tax for non-resident shareholders and cannot be declared to be conduit foreign income.

The Bill has been referred to the Senate Economics Legislation Committee, in particular because of concerns with the two franking-related matters. The Committee is due to report by 26 May 2023.

Background and scope

Broadly, the franked distributions and capital raisings measure evolved from a specific integrity concern outlined in Taxpayer Alert TA 2015/2 which was followed up by a related announcement in December 2016 to change the law as part of 2016-17 MYEFO. The matter did not receive a lot of attention at that time as it was considered to be a niche arrangement and remained as an announced but unenacted measure (ABUM) until an Exposure Draft (ED) was issued by Treasury in September 2022.

The ED proposed that the measure was effective from December 2016. Pleasingly, the Bill modifies the start date to apply to distributions on or after 15 September 2022.

The revenue estimates in the original MYEFO announcement and the Bill indicate that the measure will have a $10m per annum impact on receipts (which supports the view that this issue is limited in scope). The Australian Financial Review reported on 26 August 2022 that "Australian companies are on track to pay out more than $100 billion in dividends in the 2023 financial year[1]". By any measure, the in-scope distributions based on the revenue estimates represent a tiny proportion of annual distributions.

Unfortunately, the seemingly targeted scope of this measure is not reflected in the words of the Bill. Indeed, the breadth of the measure as drafted, suggests that the potential effect is much wider. Further, where the measure applies to a distribution, the whole distribution is treated as unfrankable. For example, if a company pays a $1,000 dividend and a capital raising of only say $50 was identified as being relevantly connected, the whole of the $1,000 dividend is unfrankable.

The explanatory memorandum (EM) contains 4 examples. Whilst the examples provide some useful guidance, they are at the more extreme end of the spectrum, leaving a large zone of uncertainty in between.

The start date is now some 6 months ago, the measure will not become law until June 2023 at the earliest, and meanwhile, companies are grappling with considerable uncertainty due to the breadth of the rules and the risk of a wholly unfrankable distribution if the rules are applicable.

Outline of the changes

Broadly, the measure applies to a distribution (the **relevant distribution**) of a kind made by an entity if three conditions are met:

1) The distribution is **not** in accordance with a practice of the entity of making distributions of that kind on a **regular basis**;

2) There has been an **issue of equity interests** in the entity or another entity (whether before, at or after the time at which the distribution was made); and

3) It is reasonable to conclude in the circumstances that:

    a) The **principal effect** of the issue of any of the equity interests was to directly or indirectly fund all or part of the distribution; and

    b) 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 distribution or part of the distribution.

[1] Presumably, this is referring only to listed companies

In scope / out of scope indicators

The EM contains a number of broad descriptions of arrangements that may be in scope

Scenarios where franking credits could not be released but for the capital raising

- "This [measure] ensures that arrangements cannot be put in place to **release franking credits that would otherwise remain unused** where they do not significantly change the financial position of the entity" (EM Outline)

Scenarios where franking credits released quicker than otherwise due to the capital raising

- "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 … to shareholders to enable the **accelerated release of franking credits**. This addresses concerns raised in Taxpayer Alert TA2015/2 issued by the Commissioner." (EM para 5.15).
- This measure targets: "**accelerating** the release of franking credits to members of entities in circumstances that **cannot be explained by existing distribution practices**, and which are **typically artificial or contrived**" (EM para 5.16).

Scenarios where there is unusually large distributions or franking balances

- "The arrangements may involve entities with **significant franking credit balances relative** to their recent or accumulated earnings or share capital that utilise capital raisings to fund **unusually large franked distributions** compared to their usual practice" (para 5.16).
- In respect of effect and purpose: "Where the entity has a **large amount of franking credits relative to its profits and/or share capital** then this would suggest that the arrangement to make special distributions to shareholders that **require capital raising** from shareholders is **artificial in nature** and may attract the operation of the measure" (EM para 5.48).

Regular patterns of distributions provide some protection, but beware …

On the other hand, and with respect to the regular practice: "Broadly, this [regular practice] 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" (para 5.21).

Examples summarised

The EM provides four examples summarised below (it is assumed that condition 2 is met in all examples):

	Example	Condition 1 Outside regular practice	Condition 3 Principal effect and purpose test
5.1	A capital raising followed one month later by a special distribution of the same amount	Satisfied	Satisfied
5.2	A one off fully franked special distribution A fully underwritten DRP	Satisfied	Satisfied
5.3	A capital raising to fund proposed acquisition, which does not proceed 12 months later, a distribution outside of ordinary dividend cycle	Satisfied	**Not** satisfied Genuine commercial purpose for capital raising
5.4	APRA regulated entity raises capital to meet regulatory requirements 6 months later, a distribution as per longstanding practice of paying distributions every six months	**Not** satisfied A longstanding regular practice	**Not** satisfied Genuine commercial purpose for capital raising

The measure will treat the relevant distribution in Examples 5.1 and 5.2 as unfrankable.

Detail

The measure will apply where the three tests or conditions in proposed new section 207-159(1) are satisfied.

Condition 1: regular practice

The measure will not apply where:

- The relevant distribution is of a particular "kind"
- The entity has a practice of making distributions of that kind on a regular basis, and
- The relevant distribution is "in accordance" with that practice.

It is therefore necessary to ascertain the:

- Particular kind of the relevant distribution (the **kind**); and
- Particular practice (if any) of making distributions of that kind on a regular basis (the **regular practice**); and
- Whether the relevant distribution is in accordance with that practice (**in accordance**).

Conceptually, condition 1 may be met (such that the provisions could apply) where:

- **Relevant distribution outside of regular practice**: The relevant distribution is of a particular kind, there is a practice of making distributions of that kind on a regular basis, but the relevant distribution is not in accordance with that practice. That is, there is a regular practice, there is an alignment of the kind of distribution but there is not an alignment with the practice of distributions; or

- **No regular practice**: The relevant distribution is of a particular kind, and there is no practice of making distributions of that kind on a regular basis. In the absence of such a regular practice, condition 1 is met with no further analysis.

It is necessary to particularise the characteristics of the distribution. Section 207-159(2) provides a non-exhaustive list of factors to take into account in determining whether an entity has a past practice of making distributions of a certain kind on a regular basis. These include factors such as the nature, timing, and amount of the distribution, the quantum or percentage franked, explanations given by the entity for making such distribution and any other relevant consideration.

Importantly, when testing whether there is a practice of making distributions of a certain kind on a regular basis, **certain prior distributions are to be disregarded** (section 207-159(3)), with the result that it may **not** be possible to demonstrate a regular practice for the purposes of the legislation.

Broadly, the disregarded prior distributions are

- Franked distributions; or

- Distributions that would have been franked (if they were subject to these rules)

that also meet condition 2 (sufficiently connected capital raising) and condition 3 (relevant effect and purpose).

It will be critical to test whether it is necessary to disregard certain prior distributions. As a matter of capital management or in a more general commercial sense, it may appear that there is a regular distribution practice, however, it is necessary to review prior distributions, including those made prior to the commencement of these rules in September 2022, in order to confirm that there is a regular distribution practice for the purpose of this measure. The examples provided seemingly skip over this aspect of the provisions, and give the impression that a cursory view of a pattern of distributions of a kind will be sufficient.

As mentioned, the EM now includes examples to illustrate various aspect of the bill.

Example 5.4 in the EM involves a company which has a "longstanding practice of paying [franked dividends] to its members generally every six months", and the relevant distribution is paid per that regular practice. Condition 1 is not met and the measure will not apply. At the other end of the spectrum:

- Example 5.1 involves a "special [franked] dividend … being a distribution **outside of the ordinary dividend cycle of the company and significantly larger** than normal dividends payments despite no significant change in profits for the company".

- Example 5.3 involves a "special fully franked dividend [paid] to its shareholders, being a distribution **outside of its ordinary dividend cycle**". As a result, condition 1 is satisfied. Having regard to the wider circumstances of Example 5.3 (including "a genuine commercial purpose for the capital raising"), the example concludes that these provisions do not apply as condition 3 is not met

- The relevant distributions in both examples meet condition 1.

Examples 5.1 and 5.3 highlight that taxpayers need to be also aware of the future impacts of this measure when the company next pays a dividend. After an out of cycle dividend, can it still be said that the company has a practice of making distributions of a certain kind on a regular basis, notwithstanding the last dividend?

This also goes to the more general issue of how long it takes to establish a regular distribution practice. It is to be hoped that condition 1 will be applied in a reasonable manner.

Condition 1 is necessarily problematic for those companies that have no regular practice of making distributions. Whilst many listed companies will have an expectation of paying regular or at least semi regular dividends, other companies will not: for example, newly incorporated companies, newly listed companies (following a demerger or IPO), companies with cyclical results, family and private companies or Australian subsidiaries of multinational groups. Such companies may not have regular practice of dividend payments.

Condition 2: capital raising

Condition 2 is drafted very broadly and can take in a capital raising at any time by any entity. This is a purely objective test and requires no particular nexus to the relevant distribution. It seems that condition 2 will regularly and readily be satisfied. If condition 1 is also met, all of the pressure will be placed on the tests in condition 3.

Condition 3: Effect and purpose

Condition 3 is that: it is reasonable to conclude having regard to all relevant circumstances that:

- 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 (referred to as the **principal effect test**); and
- 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 (referred to as the **more than an incidental purpose test** or **purpose test).**

Essentially, this condition is testing whether the capital raising is sufficiently connected to the "direct or indirect funding of the relevant distribution or part of the relevant distribution".

One of the important changes from the ED to the Bill is that condition 3 will be met only if it is reasonable to conclude that **both** the principal effect test **and** the purpose test are met. The ED proceeded on the basis that if either of these tests were met, condition 3 was satisfied. In practice, it is not clear to what extent this has narrowed the scope and indeed, the EM states that "In many cases, the outcome of these [two] tests would be expected to be the same".

This test is interesting as an indicator of current trends in drafting integrity measures:

- The relevant purpose test is set at a low level: a purpose "other than an incidental purpose";
- The purpose test does not focus on a purpose of obtaining a tax benefit, but simply a purpose of funding the distribution;
- The test also includes an effect or outcome test.

Two of the EM examples conclude that condition 3 is **not** met (the measures do not apply) where there is a "**genuine commercial purpose for the capital raising**":

- A capital raising to fund a proposed acquisition, where the acquisition did not proceed and a subsequent dividend is paid; or
- An APRA regulated body raising capital to meet regulatory requirements, and a subsequent dividend is paid.

Section 207-159(4) provides a lengthy non-exhaustive list of matters to be taken into account when applying condition 3. These include broadly:

- Any correlation in timing and amount between the capital raising and the distribution;
- The extent to which the financial position of the relevant entities has changed as a result of the distribution and capital raising (the examples and the EM in particular, focus on the cash position rather than the financial position more generally with respect to this point)
- The use of the funds from capital raising;
- Reasons for the issue of capital;
- The extent the capital raising is underwritten;
- An examination of the history of the franking account, distributions and share capital account;
- The extent of the relationship between the entity making the capital raise and the entity making the distribution (if different);
- The degree of correlation between the entities receiving/being offered the distribution and the entities contributing to the capital raise;
- Other distributions made by the entity; and
- Other relevant considerations.

Dividend reinvestment plans

Example 5.2 in the EM involves a one off dividend with a fully underwritten dividend reinvestment plan (DRP), and concludes that the **measure will apply in the absence of evidence** that the capital raising was for a purpose other than to fund the special dividend. One of the factors that is significant to the effect / purpose test is that the underwriting ensures **no net change in the cash position** of the company.

It will be important to obtain greater clarity about the potential consequences of DRPs generally, whether fully underwritten, partly underwritten DRP or non-underwritten.

Deloitte comments and next steps

Whatever may have been the original mischief that was of concern to the ATO per TA 2015/2, in our view, where a company has sufficient franking credits and sufficient profits and otherwise meets various existing franking integrity related rules, it is not clear why the tax outcomes for shareholders should differ as between cases where the dividend is funded (using that term broadly) by equity sources, debt sources, asset sales or otherwise.

Nonetheless, these rules now create a significant risk that will need to be managed in order to ensure effective use of franking credits, and no surprises to shareholders.

This measure is a difficult combination of extremely broad language in the Bill and the EM, juxtapositioned against some narrow examples and a forecasted small revenue impact. Both the broad language and the limited examples do not provide a great deal of certainty.

Many distributions will be at risk of the measure applying; making the relevant distribution unfrankable. This will not directly impact the tax position of the dividend paying company but will affect the tax position of shareholders (via the loss of the franking credit). Indirectly, the dividend paying company may be affected in that the company's franking balance may be greater , and out of balance with the company's accumulated profits if the measure was triggered.

It is not clear how affected or potentially affected shareholders are expected to anticipate these rules applying to their dividends: the principal tax impacts are at the shareholder level but the relevant knowledge will be in the hands of the dividend payer. Class rulings may become a way of managing the risks and in that way, shareholders can be advised of cases where the rules do not apply.

Given that the measure is proposed to be effective from September 2022, many companies will have already made distributions that may be in scope of these new measures.

Practically, companies will need to carefully manage their affairs to minimise the risk of the measure applying. This will involve inter alia:

- Monitoring progress of the measure through the Senate Economics Legislation Committee;
- Determining and documenting the company's practice of making distributions on a regular basis;
- Considering whether any prior distributions are to be disregarded for the purposes of ascertaining the regular distribution practice;
- Planning and managing future dividend distributions so that nothing is done which may inadvertently affect what would otherwise be a regular dividend practice;
- Determining and documenting that a particular distribution is or is not regarded as being in accordance with regular practice;
- Clear documentation as to the use of funding that is obtained via a capital raising; this may include a more careful consideration of press releases and public messaging;
- Considering whether any capital raisings by other entities may create risks for the dividend paying company;
- Clear documentation as to the source of funding used to pay the dividend; and
- Consideration of the consequences of these measures on various DRP arrangements.

In particular, the measure will add complexities, risks and uncertainties to various M&A transactions, and to companies that have transitioned into public ownership.

In many cases, the risks or uncertainties will be such that the prudent course of action will be to seek a ruling from the ATO. It is also hoped that the ATO can issue meaningful public guidance, however as noted above, the reality is that these rules are expected to have effect from September 2022 and the ATO is unable to provide guidance until the measure has Royal Assent.

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