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Tax Insights

Final PCG on franked distributions funded by capital raisings

On 24 September 2025, the Australian Taxation Office (ATO) issued Practical Compliance Guideline PCG 2025/3 dealing with the ATO's compliance approach to "capital raised for the purpose of funding franked distributions." The ATO also issued a compendium PCG 2025/EC3 which reflects submissions and ATO responses following the issue of PCG 2024/D4 on 4 December 2024.

The PCG relates to amendments contained in Schedule 5: Franked distributions funded by capital raisings, of the Treasury Laws Amendment (2023 Measures No. 1) Bill 2023, and which applies to distributions made on or after 28 November 2023. The operative provisions are in section 207-159 of the Income Tax Assessment Act 1997.

In broad terms, the explanatory memorandum (EM) describes the amendments as being directed at the payment of franked distributions associated with arrangements that are entered into for a purpose (other than an incidental purpose), and with the principal effect, of 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. Where the provisions apply to a distribution or a part of a distribution, so much of the distribution is unfrankable. The provisions are self-executing and do not depend upon the making of a determination by the ATO.

Background

The provisions had a prolonged and difficult passage through parliament which involved a deferral of the start date, referral to the Senate Standing Committee for the Scrutiny of Bills, referral to the Senate Economics Legislation Committee, government amendments in the Senate, and a supplementary EM which:

- Dealt with the government's amendments; and
- Also made "corrections" to the original EM dealing with:
    - Past distribution practices;
    - Dividend reimbursement plans (DRPs). The supplementary EM stated that DRPs including underwritten DRPs "undertaken for normal commercial purposes are not intended to be affected by the operation of the measure"; and
    - Family or commercial dealings of private companies. The supplementary EM stated that "family or commercial dealings of private companies where the capital raising and distribution are initiated to facilitate the departure of one or more shareholders from the company are not intended to be affected by the operation of the measure." By way of example, this includes:
        - Succession planning: "where, as part of a succession plan, a new generation of family members funds and acquires equity in the company and the funds are applied to pay a franked dividend to the exiting generation of shareholders"; or
        - Shareholder exits: "to allow a particular shareholder to exit the company (e.g., due to a falling-out between family members), where the departing shareholder is paid a franked dividend funded by capital raised from those shareholders who remain."

The overall effect of the Senate amendments and the comments in the supplementary EM was to narrow the effect of what was otherwise an extremely broad provision that could have the effect of treating many distributions as unfranked.

Helpfully, the "corrections" to the original EM have informed the ATO's compliance approach. It is not clear that the supplementary EM necessarily reflects the legislation as passed, so caution should be taken as there may be a divergence between the ATO's compliance approach and the position that a court may reach.

PCG framework

The PCG sets out a green/low risk zone and a red/high risk zone, and also acknowledges that there is effectively a "grey zone" where an arrangement will not be categorized by the PCG as either low risk or high risk. The PCG only focusses on section 207-159 and does not consider any other provisions which may apply.

- Where an arrangement is in the green/low risk zone, the ATO will generally not have cause to apply compliance resources to review the arrangement except to confirm the green zone requirements are met.
- Where an arrangement is in the red/high risk zone, the ATO will likely apply compliance resources and commence a review or audit.

The PCG also provides some comments on the documentation that should be retained to support a position.

Overview of section 207-159

A distribution will relevantly be unfrankable where four conditions are met in respect of the distribution:

- The distribution is not in accordance with the entity's established practice of making distributions, or there is no such established practice;
- There is an issue of equity interests by the entity or another entity, whether before or after the relevant distribution;
- There was a principal effect and a more than incidental purpose that the equity issue funded a substantial part of the relevant distribution or the relevant part; and
- The issue of equity interests was not a direct response to Australian Prudential Regulatory Authority or Australian Securities and Investments Commission regulatory requirements.

Key changes between the draft and final PCG

- The ATO states that "where the issue of equity interests funded (directly or indirectly) **less than 20%** of the entire franked distribution … it will **not** be [taken to fund] a 'substantial' part [of the distribution]". This is a positive change as the percentage threshold in the draft was only 5%.
- New paragraph 23 deals with "proportionality" (i.e., how much of a dividend may be treated as unfrankable) and states:
    - "The amount of the distribution that is unfrankable is limited only to the portion directly or indirectly funded by the capital raising.
    - Where the principal effect of the capital raising is to fund the **entire distribution**, the entire distribution will be unfrankable.
    - Conversely, if the principal effect of the equity issue is to fund [only] a **substantial part of the distribution** [and not the entire distribution], the amount of the distribution that is unfrankable will be determined in proportion to the part of the distribution funded by the equity issue. For example, if AUD 70 million from the issue of equity interests funds a AUD 100 million distribution, where section 207-159 applies, AUD 70 million of the distribution would be unfrankable.
    - If **no substantial part** of the distribution was funded directly or indirectly by an issue of equity interests, then the provision will not make any part of the distribution unfrankable."
- New example 12 deals with the changed dividend practice of a company affected by economic conditions and geopolitical conflicts such that there has **not** been a consistent dividend practice in accordance with its pre-existing policy. As a result, the company is **not** in the green zone. The example goes on to describe the type of documentation that is relevant to demonstrating a (good) commercial purpose associated with an equity raising, in contrast to a (bad) purpose of funding the distribution.

Green/low risk zone

An arrangement will be in the green/low risk zone where any of the following apply:

1. The relevant distribution is consistent with the past practice over the preceding three years of distributions paid in relation to the relevant class of shares, meaning that the timing, amount, and franking percentage are all **fundamentally** consistent (but do not need to be precisely or exactly consistent);

2. The relevant distribution is made under a DRP (whether underwritten or not) undertaken for "normal commercial purposes" and which is not "artificial or contrived";

3. The issue of equity interests funded less than **20%** of the entire franked distribution;

4. The issue of equity interests met minimum APRA or ASIC regulatory requirements or maintained a "reasonable buffer" beyond the minimum requirements; or

5. A private company makes a distribution where "the capital raising and distribution are initiated to facilitate the departure of one or more shareholders from the company (for example succession planning and shareholder exits)." It can be seen from the similarity in language that the scenario 5 green zone is seeking to align with the comments in the supplementary EM.

Relevantly, the term "private company" for the purpose of the PCG takes its meaning from section 103A of the Income Tax Assessment Act 1936.

One of the many areas of concern with the measure is in connection with mergers and acquisitions (M&A), such as where the transaction involves a purchaser undertaking an equity raising to fund the acquisition, and the target company paying a pre-sale dividend to its shareholders.

The PCG addresses some of the M&A issues (example 8) but does so by reference to scenario 5 and hence on its face is limited to private companies.

Example 8 involves an unrelated purchaser (ABC) acquiring all of the shares in a private company HHCo, which has paid a dividend only once in the last 10 years, and ABC lends funds to HHCo to pay a pre-sale dividend.

The example concludes that "This arrangement will fall under scenario 5 of the green zone under this Guideline, as HH is a private company, and the arrangement is properly regarded as an arrangement where the principal effect and purpose of the capital raising is to facilitate the departure of a shareholder."

Where such a transaction involved the acquisition of a public company, it would not squarely fall in scenario 5 and would not be a green zone arrangement. The ATO states in the compendium that "While scenario 5 and Example 8 do not extend to public companies, this does not mean that a distribution made in the context of an M&A transaction for a public company will be high risk."

Red/high risk zone

An arrangement will be in the red/high risk zone where all of the following characteristics are met:

- **Timing:** There is a close alignment in the timing (for example, less than 12 months) between an issue of equity interests and the declaration or payment of the relevant distribution;
- **Special dividend, etc.:** The distribution is a "special dividend," or is otherwise unusually large (that is, a significantly higher amount, or of a significantly higher pay-out ratio or percentage of free cash flow) compared to distributions previously declared and paid by the company over the prior three years. This does **not** apply if there has been a comparable increase in the company's profit that aligns with the special dividend or unusually large distribution; and
- One or more of the following is present:
    - **No commercial purpose:** There is an absence of evidence for a clear and genuine commercial purpose (other than releasing franking credits) for the features of the arrangement;
    - **Financial position:** There is no change, or minimal change, in the financial position of the entity as a result of the arrangement;
    - **Substantial:** Most of the funds raised by the equity issuance are used to fund the relevant distribution; or
    - **Artificial or contrived:** It forms part of an artificial or contrived arrangement designed to facilitate the lease of franking credits.

The compendium states that "special dividend" is a commonly used term to describe dividends in the market. It is defined by the Cambridge dictionary as "part of the profit of a company that is paid to shareholders in addition to one of the normal payments."

The PCG contains two examples of red zone arrangements, which are regarded as artificial and contrived, in addition to example 4.

Deloitte Australia's comments

The law is drafted very broadly and in a number of respects, it is difficult to reconcile the supplementary EM with the law. Given these difficulties, the ATO has a real challenge to moderate the potential application of these provisions so as to target those transactions that could reasonably be regarded as in-scope arrangements.

The strongest takeaway from the green zone arrangements is the comfort that is provided for most DRP arrangements, which should generally not be affected by these provisions.

As drafted, the red zone is reasonably confined, and the examples indicate that it is targeted at artificial and contrived arrangements.

It is however expected that there will still be many arrangements that fall within the undefined grey zone and for which taxpayers will likely want to seek a ruling to confirm the non-application of these provisions. That is likely to prove challenging for the ATO in terms of resources and for participants in transactions, especially those which have a short period to completion.

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