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Tax Insights

Draft PCG on franked distributions funded by capital raisings

Snapshot

On 4 December 2024, the Australian Taxation Office (ATO) issued PCG 2024 / D4 dealing with the **ATO's compliance approach to "capital raised for the purpose of funding franked distributions".** This relates to **Schedule 5, Franked distributions funded by capital raisings** amendments contained in 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.

Submissions on the draft PCG close on 31 January 2025.

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
- 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 were 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.

Draft PCG framework

The Draft 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 categorised by the PCG as either low risk or high risk. The Draft 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 have cause to apply compliance resources and commence a review or audit.

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

Overview of section 207-159

A distribution will relevantly be **unfrankable** to the extent that **four conditions** are met in respect of the entity making the distribution:

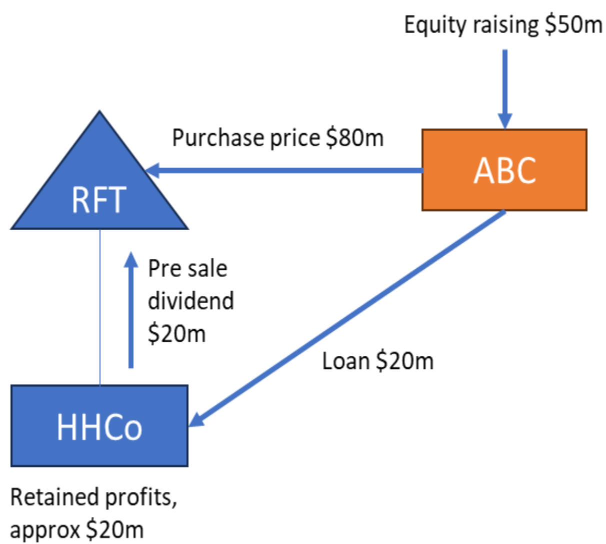
- The distribution is not in accordance with the entity's established practice of making distributions, or there is no such established practice;
- There is an issue of equity interests by the entity or another entity, whether before or after the relevant distribution;
- There was a principal effect 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 & Investments Commission regulatory requirements.

Green / low risk zone

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

- The relevant distribution is consistent with past practice over the **preceding three years** in terms of **timing, amount and franking percentage**;
- The relevant distribution is made under a **DRP (whether underwritten or not)** undertaken for "normal commercial purposes" and which is not "artificial or contrived";
- The issue of equity interests funded **less than 5%** of the entire franked distribution;
- The issue of equity interests met minimum regulatory requirements or maintained a "**reasonable buffer**" beyond the minimum requirements;
- 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.

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



The draft 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.

The example involves an unrelated purchaser (ABC) acquiring all of the shares in a private company HHCo, where HHCo 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.

Red / high risk zone

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

- 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;
- The distribution is a "**special dividend**", or is otherwise **unusually large** compared to distributions in respect of ordinary shares previously declared and paid by the company over the prior three years, **without a corresponding increase in the profit** of the company; and
- **One or more** of the following is present:
    - There is an **absence of evidence for a clear and genuine commercial purpose** (other than releasing franking credits) for the features of the arrangement;
    - There is **no change, or minimal change, in the financial position** of the entity as a result of the arrangement;
    - **Most of the funds** raised by the equity issuance are used to fund the relevant distribution; or
    - It forms part of an **artificial or contrived arrangement** designed to facilitate the release of franking credits.

The PCG contains two examples of red zone arrangements, which are regarded as artificial and contrived.

Deloitte 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 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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