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Virginia Gogan
Australian Taxation Office

***By Email:*** *Virginia.Gogan@ato.gov.au*

Dear Virginia

**PCG 2024/D4 - CAPITAL RAISED FOR THE PURPOSE OF FUNDING FRANKED DISTRIBUTIONS**

1. Thank you for the opportunity to provide comments on Draft Practical Compliance Guideline PCG 2024/D4 ("**Draft PCG**") about its compliance approach in respect of section 207-159 of the *Income Tax Assessment Act 1997*[1].

2. We highlight that for the purposes of Division 30 of the *Tax Agent Services Act 2009* and, in particular, the amendments made to the Code of Conduct by the Determination, all of the comments made in this submission are directly relevant to us as a firm and our clients. While this may result in a conflict of interest for the purposes of section 20 of the Determination, we highlight that we have tried to ensure that our comments and suggestions contained in this submission are balanced and consistent with the policy principles and intention of the rules as we understand them.

3. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we advise many taxpayers that would need to consider and apply the Draft PCG and the Commissioner's interpretation as contained in the Draft PCG (i.e. as the guideline will require consideration on the payment of each and every dividend paid by a private company).

4. We highlight paragraph 4 of the Draft PCG which explains that section 207-159 is an integrity measure addressing the concerns raised in Taxpayer Alert 2015/2, which arose out of arrangements involving listed public companies, particularly those with substantial shareholdings held by large institutional superannuation funds. In particular, we highlight that these factual circumstances are not relevant to private companies seeking to pay a dividend to shareholders in the ordinary course of their operations.

[1] All legislative references in this document are to this Act unless otherwise stated.



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5. We are concerned that the Draft PCG still provides little guidance or safe harbours that are specifically addressed at the middle market. Without appropriate practical guidance targeted at the middle market, middle market taxpayers may find it difficult to apply section 207-159 to their circumstances with relative certainty. Unlike large listed companies, closely-held companies do not generally have the same kinds of established dividend practices and therefore may find it difficult to show that the condition in paragraph 207-159(1)(a) is not satisfied. Further, closely held groups with trusts structures are not able to consolidate for tax purposes so that internal transactions, which may involve franked distributions, are not able to be disregarded under the single entity rule. Such internal distributions are not the kind that were the subject of scrutiny in TA 2015/2 and not at the forefront of Treasury's concerns when introducing the provision. However, many taxpayers in the middle market may enter into ordinary commercial arrangements that call into question the potential application of section 207-159 (on the words of the legislation) where there is otherwise no tax mischief. For example, where a dividend is paid to an individual shareholder on the top marginal tax rate (and that pays 'top-up tax' on the dividend), where that dividend is used to fund 'equity' in the same company.

6. We outline below our key suggestions regarding the Draft PCG to better provide certainty to taxpayers in self-assessing the application of section 207-159 to their circumstances.

*Technical positions should be supported by a binding taxation determination*

7. We are concerned that a technical interpretation of section 207-159 is one for which arrangements covered by green zone scenario 3 of the Draft PCG is nevertheless caught by the provisions. This is because section 207-159 can apply where the principal effect and purpose of the issue of equity interests is the funding of any part of a distribution.

8. Where, for example, the amount of equity raised is 1% of the franked distribution, it could be concluded that the sole purpose and effect of raising the equity is to fund that part of the distribution. Even though the other 99% of funding can clearly be identified as being from other sources, arguably this does not detract from the fact that the only use of the capital raised was to fund dividends of some amount.

9. We are concerned that this leaves taxpayers in an uncertain position as they may not be able rely on a non-binding PCG to support their position. That is, even though the capital raised funded less than 5% of the entire distribution, it funded 100% of a relevant part of a distribution and a PCG green zone scenario is insufficient for taxpayers to sell-assess the application of the provision.

10. We believe it is critical that the Commissioner explains his interpretation of the provision and the relevant factors in relation to this issue and provide a binding view.

11. We believe a view could be sustained that allows one to conclude that the purpose and effect test is not satisfied, even in respect of a relevant part of a distribution, where the amount of equity raised is small compared to the distribution being tested.

12. This might not necessarily mean that the provision cannot apply in cases where the amount of capital raised is less than 5% of the entire distribution, but should confirm that the provisions can be interpreted in a way that does not always result in the conclusion that a small amount of capital raised necessarily funds an equal amount of a franked distribution (i.e. the entire amount of the relevant part of the franked distribution).

13. We believe that this view can be supported by paragraph 3.12 of the Supplementary Explanatory Memorandum which states that:

    *The amount of the distribution that is unfrankable is only limited to the portion funded by the capital raising.*

14. That is, the introduction of the concept of "relevant part" was included after the original introduction of the Bill. Previously, it operated in a way that would render the whole distribution unfrankable if only a portion of it was funded by the capital raising, as outlined in paragraph 5.36 of the Explanatory Memorandum:

    *Even if the test is satisfied only in relation to some of the capital raised from an issue of equity interests or part of a franked distribution, the entire distribution ceases to be able to be franked. This is to deter entities entering into these arrangements.*

15. A binding view by the Commissioner should explain that the "relevant part" concept should be read consistent with achieving the ultimate purpose of the provisions, as opposed to the original purpose before the amendments were made. As a basic example, $90 million capital raised may be said the fund a substantial portion of a $100 million distribution. Section 207-159 applies so that only $90 million of the $100 million distribution could be made unfrankable under section 207-159. If instead $2 million of capital raised funded a portion of a $100 million distribution, it can be concluded (depending on the circumstances) that no amount of the distribution is unfrankable.

16. We request that a taxation determination on this issue be issued by the Commissioner. The taxation determination does not need to state the "safe harbour" threshold (i.e. of 5%), which we agree is appropriate to include in the Draft PCG. However, without a technical basis, the Draft PCG alone is insufficient to provide taxpayers certainty on this issue.

*Tax liability associated with franked distribution*

17. Section 207-159 does not contain a tax purpose test. However, the last of the factors that must be taken into account when considering the third criterion (i.e. the principal effect and purpose test) is "any other relevant consideration". We believe that it is critical that the PCG clearly state that tax outcomes will be considered as a relevant consideration for the Commissioner in allocating compliance resources.

18. We note that most shareholders of closely held companies are entities whose marginal tax rate is greater than or equal to the corporate tax rate. Such structures generally often prefer to reinvest profits at the corporate tax rate rather than accelerate the early release of franking credits. Consistent with the stated purpose of the measure, the distribution of franked dividends in a way that provides no tax advantages (or may in fact accelerate 'top-up tax') should prima facie be those to which section 207-159 does not apply. This is a crucial consideration that must be given as it suggests that the relevant arrangement is done for genuine commercial purposes.

19. Using the example outlined earlier, where a dividend is replaced by 'equity', the 'equity' interest (e.g. an interest-free loan) can provide a shareholder with added security (i.e. which is a better security interest to hold as compared to a share with dividend rights). Accordingly, the fact that top-up tax has been paid should be sufficient to demonstrate that the commercial rational (i.e. to create a security interest for the owners) is the primary motivation for undertaking the transaction.

20. If the facts in example 10 of the PCG were changed such that the Border Trust had no tax losses and either the trustee or its beneficiaries paid tax at the top marginal rate on the dividend, there should (on its face) be a presumption that there is a clear and genuine commercial purpose as there is no advantageous or accelerated use of marginal tax rates or other attributes such as tax losses. The conclusion should be that in the absence of some other form of contrivance or artificiality, the arrangement is not a red zone arrangement.

21. We believe that the PCG could contain two scenarios providing certainty on low risk arrangements.

    21.1. The PCG should contain a green zone stating that distributions taxed at the top marginal rate are at low risk of the Commissioner having cause to allocate compliance resources. While we acknowledge that it is possible for the provision to apply in such circumstances, we believe that it is not a sensible use of resources for the Commissioner to audit such arrangements and such shareholders should have a degree of comfort in a PCG.

    21.2. Where all eligible shareholders have a tax rate that is equal to or greater than the corporate tax rate which do not utilise any losses against the distribution, the PCG should make some comments that these are factors that make it less likely that the Commissioner will dedicate compliance resources to their arrangements. We note examples 11 and 12 are both ones which are not in either the green zone or the red zone and both conclude that the company is able to or in a position to demonstrate a “commercial purpose of the equity issuance and use of funds”. Where there is an absence of any apparent tax benefits, it should be presumed that there is a commercial purpose for the arrangement. We note that internal transactions such as the refinancing and consolidation of intra-group loans and unpaid present entitlements between group members are examples of ordinary transactions commonly done for commercial reasons such as simplifying structures and administration of the group, protecting entities at-risk of being sued and compliance with banking covenants. As dividends are often required to be paid in order to facilitate Division 7A loan repayments, we believe that this is a critical safe harbour that is required in the PCG.

*Arrangements motivated by asset protection*

22. Further to the comments above, closely-held groups often seek to reduce the net assets of trading entities that are at high risk of being sued and commonly seek to distribute profits out of the company at the earliest opportunity. This may simply involve paying franked dividends up to a holding company.

23. Where the trading company requires the continual use of the funds, they may seek to obtain the funds by way of loan, which the holding company may look to secure. Where this is an at-call loan, it can be classified as an equity interest for tax purposes.

24. Alternatively, there may arrangements involving more than two entities such as where the shareholder uses the dividend to subscribe for ordinary shares in a different company which lends the money back to the original trading company. This loan in may be either a debt interest or an equity interest, but the issuance of shares by this other company creates the potential for the application of section 207-159 (e.g. similar to the issuance of equity and loan in by ABC to Hawks Harvest in example 8 of the Draft PCG).

25. Where there is no apparent tax benefit (e.g. no use of tax losses or favourable tax rates) and the arrangement is explicable by asset protection as the principal purpose, these kinds of arrangements should be the subject of an example in the PCG stating that they are low risk of the Commissioner having cause to apply compliance resources (or otherwise be considered similar to examples 11 and 12 which conclude that the ability to demonstrate a commercial purpose will assist the company in demonstrating that section 207-159 does not apply in such circumstances).

*Established practice where distributions made to comply with Division 7A requirements*

26. We note that the Draft PCG (in Table 2) states that an amount of a distribution can be consistent where a pay-out ratio or percentage of free cash flow is consistent. We recommend that that the PCG also state that if the amount of the dividend is one that is paid in order to comply with Division 7A (i.e. the minimum yearly repayment formula in section 109E of the *Income Tax Assessment Act 1936*) then this should also be considered to be consistent and able to support the conclusion that the dividend is one consistent with an established practice.

27. Division 7A loans are commonly dealt with by way of dividend and set-off and driven by the statutory formula. These are genuine established practices adopted by private companies who commonly pay dividends for these reasons as opposed the reasons that large listed companies pay dividends (i.e. a closely-held company is not motivated by a need to keep investors happy and create demand for their stock). The PCG should acknowledge and recognise that closely-held companies establish dividend practices for vastly different reasons to widely-held public companies and would not be expected to adopt similar metrics in order to establish a practice of paying dividends of a particular kind.

28. Accordingly, to the extent that a private company has a history of paying dividends for Division 7A compliance (even if such dividends are ad-hoc), that this would be considered an established practice.

*Practice established by other group entities*

29. We note paragraph 19 of the Draft PCG which states that the mere existence of a board-endorsed policy or published dividend policy is not sufficient by itself to constitute the establishment of a practice. However, we believe the Commissioner could take into account, as a relevant consideration, the practice established by other entities in the same group. If too strict an interpretation was taken, this would disadvantage newly established entities (in non-consolidated groups) that may merely act as another vehicle that otherwise carries out the group's overall objectives.

30. An example may be where a holding company is interposed (e.g. pursuant to a Division 615 roll-over). If that holding company immediately adopts a practice consistent with the original company's it should be considered to have that practice from inception, rather than having to wait over 3 years before it can be covered by green zone scenario 1.

31. Likewise, a group may establish a new company for each project or separate location it expands to. Such entities should also be able to benefit from the group's existing dividend practice rather than having to wait three years. For example, the new company may immediately start paying dividends using the exact same frequency and exact same metric (e.g. percentage of free cash flow) as all other companies in the group that conduct the same kind of activity.

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If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director