31 March 2023

Mr Alan Raine
Senate Economics Legislation Committee
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Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir,

Submission to the Inquiry into Treasury Laws Amendment (2023 Measures No.1) Bill 2023

The SMSF Association welcomes the opportunity to provide a submission to the Senate Inquiry into this Bill. Our submission focuses on Schedule 5 to the Bill which seeks to prevent certain distributions that are funded by capital raisings from being frankable.

We support measures that prevent tax avoidance and the manipulation of the franking system to facilitate the inappropriate release of franking credits. However, we are concerned that the amendments contained in Schedule 5 to the Bill, will inadvertently catch many normal and legitimate situations.

Schedule 5 to the Bill adds distributions funded by capital raising to the list of distributions that are unfrankable. A distribution by an entity is funded by capital raising if, broadly:

- The distribution is not consistent with an established practice of the entity of making distributions of that kind on a regular basis.
- There has been an issue of equity interests in the entity or another entity; and
- It is reasonable to conclude that the principal effect of the issue was to fund all or part of the distribution.

To accommodate the above, the amendments include several items that must be tested to determine whether a distribution is funded by capital raising. The first test for the amendments to apply is that the distribution must not be consistent with an established practice of the entity of making distributions of that kind on a regular basis.

However, there may be many legitimate situations that would not satisfy the "established practice" requirement. Some examples include:

- New companies which have only recently commenced operations and therefore have no established record of paying dividends

- Companies operating in highly volatile and uncertain industries where dividends may only be paid irregularly
- Companies which are restructuring or growing quickly and have high reinvestment needs and may only pay dividends irregularly
- Companies who pay special dividends due to abnormal profits
- Companies who ordinarily reinvest their profits and raise capital as part of their normal cash flow management practices.

To avoid the amendments applying to legitimate and normal business operations, and to avoid uncertainty, the proposed considerations in subsection 207-159(2) should be extended to include a broader list of matters which will be taken into account when considering whether a distribution satisfies the requirements to be a distribution funded by a capital raising under subsection 207-159(1). Without this modification, this subsection is too narrow and ambiguous and risks competitively disadvantaging profitable and growing companies.

Another test that must be satisfied for a distribution to be unfrankable is that it must be reasonable to conclude that, having regard to all the relevant circumstances, the issue of an equity interest must have had the principal effect of funding the distribution or part of a distribution. This requirement tests whether the capital raising by the issue of equity interests has funded the distribution.

It is not unusual for companies to reinvest their profits back in the company rather than merely holding their profits as cash to be distributed to shareholders. Companies that generate profits that are reinvested, can only generate the cash required to pay a dividend by:

a) raising debt
b) selling some of its assets or investments; or
c) by raising capital.

Raising debt may not always be possible or desirable, and selling assets or investments can be costly and may also not be possible or desirable. Raising capital is often the preferred option as it frees up cash from previously earned reinvested profits. It also enables the company to avoid the costly and undesirable need to sell assets which may have only been recently purchased.

The reinvestment of company profits and the raising of capital to pay dividends, for many companies, is merely prudent cash flow management and has nothing to do with tax avoidance or the manipulation of the franking system. The raising of capital simply provides liquidity from previously earned profits enabling a dividend to be paid from those profits.

Under the proposed amendments a company which reinvests its profits and raises capital to pay a dividend is very likely to have an unfrankable distribution because the principal effect or purpose of the capital raising is to fund a dividend.

Disallowing franking in these situations would expose the shareholders to double taxation. Company profits would still be subject to tax, but the shareholder would receive an unfranked dividend with no franking credit to offset the tax paid by the company. The company will have no retained profits, however, will have a significant franking credit balance trapped within the company.

The amendments should not apply in situations where a company has legitimately earned profits and seeks to distribute those profits to its shareholders. Disallowing franking in these situations could severely disrupt the normal and legitimate cash-flow activities of many growing and profitable companies.

To avoid these unintended consequences, subsection 207-159(1) should be modified to make it clear it will not apply to distributions in situations where a company has made a taxable profit, those profits have been applied in funding the operations of the company, and the company now intends to distribute those profits as a dividend. Making this modification will ensure this subsection appropriately targets the mischief it is intended to address.

If you have any questions about our submission, please do not hesitate to contact us, and we thank you again for the opportunity to provide this submission.

Yours sincerely,

Peter Burgess
Chief Executive Officer
SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing the self-managed superannuation fund (SMSF) sector which is comprised of over 1.1 million SMSF members and a diverse range of financial professionals. The SMSF Association continues to build integrity through professional and education standards for practitioners who service the SMSF sector. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial advisers, tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them with access to independent education materials to assist them in the running of their SMSF.