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31 March 2023

By online

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee Members

Treasury Laws Amendment (2023 Measures No. 1) Bill 2023

Gilbert + Tobin wishes to comment on *Treasury Laws Amendment (2023 Measures No. 1) Bill 2023* (**Bill**) and welcomes further consultation on the Bill.

1 About Gilbert + Tobin

Gilbert + Tobin is recognised as a leading transactions, regulatory and disputes law firm. We handle some of the most complex transactions in Australia and we are trusted by clients on sensitive regulatory investigations and approvals, litigation and Royal Commissions.

We advise on a broad range of tax matters, including in large public markets transactions. We draw on our extensive experience in these areas in making this submission.

2 Summary

We make no comments on the Bill, other than in respect of Schedules 4 and 5.

We recommend changing Schedule 4, which covers off-market share buy-backs by listed public companies, by removing the adjustment for the market value of the shares bought back. This change would align the tax outcomes of off-market share buy-backs by listed public companies with those of on-market share buy-backs (consistent with the overarching principle of the proposed amendments).

We also recommend changing Schedule 5, which covers franked distributions funded by capital raisings. The current schedule creates unnecessary complexity and uncertainty in public markets transactions. It makes it difficult for the Commissioner of Taxation (**Commissioner**) to administer his role properly, creating risks for shareholders and directors. We propose some amendments that address these concerns without compromising the policy intentions behind Schedule 5.

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3 Schedule 4 – Off-market share buy-backs

The stated objective of Schedule 4 is to:[1]

> … [improve] the integrity of the income tax system by aligning the tax treatment of off-market share buy-backs undertaken by listed public companies with the tax treatment of on-market share buy-backs. …

Section 159GZZZQ(2) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) substitutes what the market value of the shares would have been if an off-market buy-back did not occur for the actual buy-back price to determine the tax consequences of the buy-back. The Commissioner has adopted a method for determining this market value.[2] On-market buy-backs are not subject to this adjustment.

The Bill does not remove this adjustment for listed public companies, which goes against the goal of making the tax outcomes the same for the two types of buy-backs.

We submit that Schedule 4 should be amended by inserting a new section to the following effect:

> **X At the end of subsection 159GZZZQ(2)**
>
> Add:
>
> (2A) Subsection (2) does not apply if the company is a listed public company.

4 Schedule 5 – Franked distributions funded by capital raisings

Our comments specifically relate to special distributions paid when one entity (usually a company) purchases another. We do not intend to detract from the merits of Schedule 5 in other contexts. We recognise that our recommended changes may require some adjustments to avoid unintended consequences in other situations, and we are happy to collaborate with the Committee and Treasury to refine our recommendations. Therefore, we have not proposed any changes to Schedule 5's wording at this point.

4.1 Example

Our concerns are best explained using an example of a typical transaction. The potential application of the Bill to several current deals has gained media attention – this commentary may also be helpful to the Committee.

> *Example: Company Buyer offers to buy all the shares of listed Company Target for $20 per share in cash, which is reduced by the cash amount of any special dividend paid. Company Target pays its shareholders a fully franked special dividend of $7 per share. Therefore, Company Buyer buys each share for $13 in cash.*

4.2 The impact of franking credits on shareholder value

It is not surprising that the availability of franking credits is a crucial factor in determining the total value that shareholders receive, which in turn affects their decision on whether to accept the bid. Here is a

[1] Paragraph 4.1, Explanatory Memorandum to the Bill.
[2] Refer to *Taxation Determination TD2004/22*.

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table that demonstrates the various after-tax outcomes for different types of shareholders using the example provided above:[3]

		Individual with effective tax rate of 47%[4]	Individual with effective tax rate of 21%[4]	Superannuation fund (tax rate of 15%)	Company (tax rate of 30%)
A	After-tax cash receipt if fully franked special dividend is paid	$16.42	$20.06[5]	$20.70[5]	$17.60
B	After-tax cash receipt if no dividend is paid	$16.48	$18.43	$18.50	$15.50
C	After-tax cash receipt if unfranked dividend is paid	$14.83	$17.69	$18.15	$15.50

The table clearly indicates that, except for shareholders on the highest marginal tax rate, all other shareholders would receive a lesser amount if *no* dividend is paid.

Worse still, if an unfranked dividend is paid, all shareholders (other than companies, who would be indifferent) would end up with a smaller amount than they would have if *no* dividend is paid. Hence, we have not come across any transaction where an unfranked special dividend is paid.

4.3 Impact for shareholders if the measures apply

Shareholders to keep ongoing vigil over a company they no longer have an interest in

The difficulties caused by the measures in transactions arise because the measures consider capital raisings "in the entity [paying the distribution] or *any other* entity (whether before, at or *after* the time at which the relevant distribution was made)".[6]

Schedule 5 applies automatically. It does not require any action by the Commissioner (this is different from the anti-avoidance provisions in section 177EA of the ITAA 1936 and section 204-30 of the ITAA 1997).[7]

[3] Each shareholder is assumed to be a resident for Australian tax purposes, have the same cost base of $5 in each Company Target share, have no capital losses, have held the Company Target shares for at least 12 months so as to be entitled to the capital gains tax discount, and satisfy the 45 day rule. It is assumed that the Commissioner will not apply any anti-avoidance rules to deny the franking credits.
[4] Including the Medicare Levy of 2%.
[5] The after-tax cash receipt is higher than the scheme consideration because of a refund of excess franking credits under Divisions 63 and 67 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).
[6] Section 2 of Schedule 5 of the Bill inserting section 207-159 into the ITAA 1997.
[7] Section 202-45 of the ITAA 1997, which treats a dividend as unfrankable, does not require the Commissioner to exercise any discretion. Instead, the measures in Schedule 5 comprise the sole triggers for treating a special dividend as unfrankable.

As a result, each shareholder must decide for themselves if the measures apply. Schedule 5 creates uncertainty for shareholders because it considers events that happen after the transaction is completed. This means that shareholders must keep a close watch over a company in which they are no longer a shareholder and have no rights over. Also, the group of entities considered as “any other entity” captures the buyer group after the transaction is completed, and shareholders must take into account transactions within the buyer’s corporate group (which may not be publicly known).

In fact, it is conceivable that two shareholders could take different positions on the application of Schedule 5, partly due to them having different information about the relevant facts and partly due to their weighting of the factors relevant to the application of the measures!

Shareholders worse off than if no dividend had been paid

If Schedule 5 applies, shareholders will be treated as if they received an unfranked dividend (row C in the above table), which is worse than not receiving any dividend at all (row B in the above table). Directors must choose whether to pay a special dividend knowing there is a risk that doing so could harm shareholders financially. Instead, they could choose to let the buyer pay a higher price for the shares. They must make this choice well before all the facts can be known because the measures look at events that happen after the transaction is completed (when they are no longer directors in control of the company paying the dividend or of the buyer group).

Certainty cannot be obtained from the Commissioner

In transactions like this, it is common to seek class rulings from the Commissioner regarding the availability of franking credits because these credits are important in determining the value to shareholders. However, the Commissioner cannot predict what the buyer group may do after the transaction, so he cannot rule on how these measures would affect the availability of franking credits.

Additionally, the Commissioner may not engage with the buyer or take its intentions into account when making a ruling (if he could make a ruling) because the buyer is neither the applicant nor amongst the class of shareholders affected by the transaction.

Summary

It is clear that Schedule 5 is impractical for shareholders in the context of a transaction like the one illustrated in the example. Schedule 5 creates unwarranted uncertainty and lacks simplicity, imposing a significant compliance burden on shareholders. Moreover, the level of evidence demanded by Schedule 5 may be well beyond the reasonable reach of the majority of shareholders. These factors combine to make Schedule 5 an unworkable provision for shareholders (and the Commissioner).

4.4 Issues for directors, independent experts, ASIC and the Court

Directors’ decision to pay a special dividend is made difficult by the complexity of Schedule 5 because directors must decide whether to pay a dividend (taking into account the availability of franking credits) far earlier than the period of time after the transaction that Schedule 5 could take into account to deny the franking credits.

The application of Schedule 5 also needs to be taken into account in the scheme booklet, which must provide guidance on the availability of franking credits attached to the special dividend. The same timing issue affects the clarity and certainty that the scheme booklet can provide.

Independent experts may take the franking credits into account in assessing whether the proposed transaction is fair or reasonable. The Australian Securities & Investments Commission (**ASIC**) reviews the scheme booklet, as does the Supreme Court or the Federal Court, and they will need to be comfortable with the scheme booklet (including statements about the availability of franking credits).

Schedule 5 makes each of the above tasks difficult. Directors, in particular and despite their best efforts, are potentially exposed if events occur after the transaction that endanger the availability of the franking credits.

4.5 Recommendation

The current situation is untenable for all parties involved in the development and implementation of transactions, particularly the shareholders. However, the solution is clear: turn off the potential application of Schedule 5 in the case of special distributions paid in connection with a transaction involving the change of some or all of the ownership of the entity making the distribution. This simple solution will alleviate the uncertainty and complexity that currently exists with Schedule 5, providing greater clarity for all parties involved.

To address any potential for abuse, the Commissioner could be granted the power to deny franking credits, similar to powers he already holds under section 177EA of the ITAA 1936 and section 204-30 of the ITAA 1997. This would allow the Commissioner to rule *at the time of distribution*, based on the information, schemes and plans in place *at that time*. Furthermore, the Commissioner should be given the power to impose a debit to the entity's franking account instead of pursuing the shareholders, providing an efficient and effective means of managing any potential issues.

Alternatively, a simpler solution involves treating a special distribution to which the measures in Schedule 5 apply as part of the capital proceeds, not as an unfranked dividend.[8] This solution would replicate the tax outcomes that would have arisen for shareholders had the directors chosen not to pay a special dividend as part of the transaction. Importantly, this solution allows directors to express both potential outcomes with certainty, enabling shareholders to make an informed decision about the merits of the transaction. This solution requires less redrafting and imposes less of a burden on the Commissioner, providing a more practical and efficient solution for all parties involved.

We hope these submissions are of assistance to the Committee.

Yours sincerely
Gilbert + Tobin

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Muhunthan Kanagaratnam
Partner

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[8] This treatment would reverse the application of the Commissioner's views in *Taxation Ruling TR2010/4* in this limited situation.