Submission to the Senate Economics Legislation Committee Treasury Laws Amendment (2023 Measures No 1) Bill 2023: Franked Distributions Funded by Capital Raisings

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Author's Credentials

This submission has been written by Graham Partington, (BSc (Hons), MEc (Hons)). I have had three decades of experience as an associate professor of finance and also as a consultant on financial issues. My teaching has been at universities in Australia, Canada, France, and the UK, and I have substantial experience in running PhD programs and supervising PhD students. My writing includes co-authoring textbooks and many research papers, and I have received several prizes for this work. A particular focus of my research has been on dividend policy and also the value of imputation tax credits. Twenty-two of my papers on these topics have been published in refereed journals. I have also supervised five PhD theses about dividends. My consulting experience covers valuation, the cost of capital, and the value of imputation tax credits.

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Introduction

This submission has been prepared to highlight the potential consequences of a proposed change to the legislation involving franking credits. The relevant change is detailed in *Treasury Laws Amendment (2023 Measures No 1.) Bill 2023 Explanatory Memorandum*; *Chapter 5: Franked distributions funded by capital raisings*. I begin by providing some brief context for my discussion and then develop more detailed analysis of the possible consequences of the proposed changes.

The imputation system was introduced to eliminate the double taxation of corporate income that arose under the previous "classical" system of taxation. The result of the operation of the imputation tax system is that corporate income distributed as dividends is taxed at the income tax rate applying to each Australian resident shareholder who receives dividends.

The operation of the imputation system has a number of economic consequences. I will simply state some of these consequences here and discuss them more fully later. The imputation system reduces the cost of capital, which stimulates investment and hence employment. It reduces the tax benefit of using debt, which results in less debt being issued and an increase in equity raising. Thus, there is a reduction in corporate leverage, and this is particularly beneficial when economic conditions deteriorate. Under imputation there is an incentive to pay out higher levels of dividends. As a result, companies have to raise more capital externally. Consequently, company management are more exposed to market discipline. Also, because shareholders can recover corporate tax paid via imputation credits there is less incentive for company management to engage in corporate tax avoidance.

The foregoing effects are good outcomes, but there is a cost. Less corporate tax revenue is likely to be obtained by the Treasury relative to that obtained under a classical tax system. However, imputation tax systems are designed with the intention to have some wastage of imputation tax credits, so that all of the corporate tax is not refunded to shareholders. The proposed changes in legislation are described as integrity measures. That is, they are intended to sustain, or increase, the wastage of imputation credits. Maintaining the integrity of the imputation tax system is a desirable outcome. However, there is an open question about whether the changes as proposed will penalise legitimate corporate financial decisions, changing corporate behaviour in a way that creates costs to the economy. Thus, there is a risk that the contribution to the budget may be offset by economic damage due to unintended consequences.

The foundations of economic reform initially laid down in the Hawke-Keating era were followed by the remarkable achievement of 29 years of continuous economic growth and no recession since 1990-1991. An important foundation stone in the Hawke-Keating reforms was the introduction of the imputation system. Therefore, it is reasonable to ask, is it wise to be adjusting this foundation stone at a time when the economic future looks particularly risky?

The answer to this question depends on the extent of the effects from the proposed change, which we discuss in the next section.

The extent of effects from the proposed change

Classifying dividends as unfrankable due to a capital raising, has been presented as a minor change. If this really turns out to be the case, then there is little need for concern. However, it is clear that there is significant concern in the investment community about the effects of this change. This is because of the risk that the effects will be far from minor. The actual effects of the proposed change will depend upon:

- The actual extent to which dividend distributions are deemed to be unfrankable due to a capital raising.
- The extent to which managers and investors expect the legislation to lead to dividends being classified as unfranked now and in the future.
- The extent to which managers change financial policies to avoid the risk that dividends will be classified as unfranked.

As a consequence of the second and third dot points it is possible for there to be substantial effects even if the revenue initially raised by the legislative change is small.

As described in Chapter 5, the conditions under which a dividend could be classified unfrankable seem quite broad, even if the intention is that they be narrowly applied. I regularly told my students that if a company raised external finance, debt or equity, and paid a dividend in the same period then the company had effectively financed all or part of the dividend externally. It seems that with respect to raising equity this logic forms part of the proposal in Chapter 5 of the explanatory memorandum. It is difficult to quarrel with this logic,[1] but it would catch all legitimate equity raisings. To avoid the risk that dividends be classified unfranked it might be necessary to rely on the established practice test and/or establishing a purpose for the issue unrelated to paying dividends. Given the definition of dividend policy as in footnote 1 below, this latter might be difficult to do. Thus, the proposed changes could well create a bonanza for lawyers.

Let us now consider the case of dividend reinvestment plans (DRPs). Following the introduction of the imputation tax system, dividend payout ratios (Dividends/Profit) have risen substantially. For dividend paying stocks, the dividend payout ratios rose from an average of about 50% to an average of about 70%. As dividend payout ratios rose there was a rapid increase in the number of companies offering DRPs and such plans are now widely

[1] The definition of dividend policy "…is the trade off between retaining earnings on the one hand and paying out cash and issuing new shares on the other." See: R. Brealey, S. Myers, G. Partington, 2000, *Principles of Corporate Finance*, McGraw-Hill, Sydney, p.450.

offered. There is little doubt that a substantial, or principal, part of the motivation for dividend reinvestment plans is to raise capital to replace some, or all, of the cash distributed as a consequence of higher payout ratios. The reason for those higher payout ratios is to distribute imputation credits.

Thus, any company with a DRP would fall foul of the criteria of an equity issue used to fund part of a dividend and distribute imputation credits. Many DRP cases would probably be saved from an unfranked dividend classification by the defence of an established distribution practice. However, there is ambiguity over what constitutes an established practice. [2]

For example, it is not unusual for companies to hold their dividend more or less unchanged for an extended period and then make a substantial increase once management is convinced that increases in profitability can sustainably support the increase in dividends. Suppose that a company has held its interim and final dividend payment constant for three years. That is six consecutive cases of no dividend change. The company now increases its dividend by 50%. Is this a departure from the established practice of no change, or part of a longer term established distribution practice? As discussed later, the issue of an established distribution practice is a particular problem for start-ups, small stocks, and growth stocks.

Chapter 5 of the explanatory memorandum provides an example where the dividend should be classed as unfranked due to a DRP. The example given is for an underwritten dividend reinvestment plan used to fund a special dividend. This example has particular resonance given current concerns about the risk of another global banking crisis. During the GFC, Australian banks had their dividend reinvestment plans underwritten. This enabled them to continue paying dividends, which was reassuring to markets, while at the same time guaranteeing the recovery of cash paid out. This helped ensure the maintenance of bank capital and the banks' financial stability.

Underwriting the banks DRPs was a good thing to do and presumably lies beyond the intended net of the legislative changes, but what if it was an individual company that adopted the same technique to pay its dividend and provide a reassuring signal to the market. Might it be caught by the letter of the law? Thus, there is a question mark over the use of DRPs, particularly if they are underwritten and the dividend is increased.

There are other cases where problems could arise with the established practice test. For example, companies initiating dividends have no established practice, companies may temporarily have abnormal high profits and pay a special dividend, stocks transitioning out of

[2] For firms initiating dividends for entirely legitimate reasons, there is no established practice to fall back on.

their growth phase may also pay abnormally large dividends and take some time to develop an established practice. It is also the case that rather than subsequent capital raisings being to finance the dividend, the causality may be reversed. A motivation for paying dividends may be to sweeten the market for a subsequent capital raising. Survey evidence shows that managers consider an important motivation for paying dividends is to make it easier to raise finance in the future.[3]

In the light of the foregoing discussion, there is a basis for concern about how the law will be applied and there is also ambiguity about the range of cases that might fall under the ambit of the proposed changes to the legislation. It is also clear, as discussed below, that the legislation may have effects on company dividend policies, the cost of capital, the use of debt financing and the level of corporate tax avoidance,

Dividend distributions and profit retention

Consider two companies, both have profits on which they pay corporate tax and hence obtain franking credits. One company, Distribution Ltd., pays out most of its earnings as dividends. Consequently, it keeps relatively little in the way of retained earnings and it also undertakes relatively little external financing, either by debt or equity. The result is that funds available for investment are only sufficient to match the depreciation of existing assets. Thus, net investment is zero. Distribution Ltd. has the characteristics of a cash cow, a mature company which has limited opportunities for profitable investment and hence distributes most of its cash flow to investors. Since it distributes most of its profits it also distributes most of the franking credits that are created from tax payments. It has a well-established distribution practice, so if management wished to fund a dividend distribution it could do so by raising equity without being caught by the legislative changes. If, in order to distribute unused franking credits, Distribution Ltd.'s management desire to increase current distributions beyond the limits of the established distribution practice, they can do so by borrowing instead of raising equity.

Thus, the proposed legislative changes seem unlikely to be a substantive problem for cash cows and more generally for mature dividend paying firms, unless they have accumulated a very large franking account balance. In respect of the latter, I note that a substantial number of large firms do have franking account balances of several billion dollars. To the extent that the proposed changes are expected to lock up franking credits, then there is a significant incentive for increased corporate tax avoidance as discussed later.

[3] See: G. Partington, 1989, Variables Influencing Dividend Policy in Australia: Survey Results, *Journal of Business Finance and Accounting*, 16:2, pp.165-182.

The other company, Retention Ltd., has historically paid out very little of its profits as dividends, indeed for a considerable period it paid no dividends at all, instead pouring all of its earnings back into new investments. Consequently, there is a substantial balance that has built up in the company's franking account. Retention Ltd. has the characteristics of a growth stock, good investment opportunities and substantial reliance on internal finance. Retention Ltd. has no well established distribution practice and when it pays dividends, it needs to raise equity in order to sustain its investment program. Thus, Retention Ltd. could well find its dividends being classified as unfranked. For growth stocks, the alternative of raising debt finance is a very undesirable option, if available at all. If it wants to pay dividends, then there would be an incentive for Retention Ltd. to make itself more like Distribution Ltd., invest less and pay out the cash so released. This outcome is undesirable.

It seems very likely that the proposed legislative changes will create problems for companies like Retention Ltd., particularly in the case of a large dividend that carries substantial franking credits. Franking credits may either be lost through the unfranked classification of dividends, or effectively be locked up inside profitable growth stocks.

There is a further problem that arises when a growth stocks ceases to have rapid growth in investment opportunities and is transitioning towards the cash cow end of the payout spectrum. Successful growth stocks often accumulate large cash balances so that they have the flexibility to quickly exploit new investment opportunities. When investment opportunities are declining rapidly it is desirable to shift much of this cash out of the company and into the hands of shareholders for reinvestment elsewhere. Now suppose the growth stock has been paying a modest dividend as growth initially slowed and also has established a DRP. It now declares a very large special dividend to distribute some of the surplus cash and maintains its DRP. With the exception that the DRP is not underwritten, this situation is the same as the explanatory memorandum example illustrating when a dividend would be considered unfranked. Therefore, there is a good reason for concern about the consequences of the transition from a growth stock to a cash cow.

Growth stocks provide a significant source of innovation in the economy and the ones that succeed generate substantial wealth and employment opportunities. If the result of the legislation is to destroy, or lock up franking credits, in growth stocks, this disadvantages the shareholders of such stocks and will increase the cost of capital to growth stocks and reduce investment. This is an undesirable outcome. Similar disadvantages would apply to start-ups and companies outside the top 500 on the ASX, many of which either do not have an established distribution policy, or currently pay no dividends.

Cost of capital effects and the value of imputation credits

The market value of franking credits is an important issue relevant to this discussion. Clearly, franking credits have value in use. The question is whether they have a value in exchange.

While it has been contested in the past, it now seems to be widely accepted that franking credits are priced in the market. In my own research I have studied the value difference between shares in the same company which are simultaneously trading, one with the dividend and franking credit and the other without the dividend. The difference in price gives a clean measure of the combined value of the dividend and the franking credit. The evidence is clear that the franking credits not only have a positive market value, but also that the value is substantial.[4] I have also studied the value of dividends and franking credits in other contexts, including price changes when stocks go ex-dividend, comparing the value of dividends on American depositary receipts with the value of dividends for the underlying Australian stocks, examining the valuation of franking credits in off-market buybacks, and analysing the pricing of dividends in short sales contracts. In all cases the evidence was that the market value of the franking credits was positive.[5]

Given that franking credits increase the value of Australian shares this is equivalent to reducing the cost of capital for Australian companies. However, if the franking credits are not distributed their value diminishes due to the discounting that occurs as a result of a delay in distribution. The value of franking credits also declines as the probability of distribution declines. If the probability of franking credits not being distributed rises to one, then the value of the franking credits shrinks to zero. Thus, to the extent that the legislative change reduces the distribution of franking credits, or leads to an expectation of deferred distribution, and/or a declining probability of that distribution, then the cost of capital for the Australian

[4] See: S. Walker and G. Partington, 1999, The Value of Dividends: Evidence from Cum-dividend Trading in the Ex-dividend Period, *Accounting and Finance*, 39:3, pp. 275-296.
H. Chu and G. Partington, 2001, *The Value of Dividends: Evidence from a New Method*, Accounting Association of Australia and New Zealand Conference, Auckland.
H. Chu and G. Partington, 2008, The Market Valuation of Cash Dividends: The Case of the CRA Bonus Issue, *International Review of Finance,* 8:1-2, pp. 1-20.
E. Lai, G. Partington, 2018, *The Value of Dividends: Evidence from Non-parri-passu Rights Issues*, International Finance and Banking Society, Latin American Meeting, Santiago.

[5] See: A. Ainsworth, K. Fong, D. Gallagher, and G. Partington, 2018, Price Pressure around the Ex-dividend Day in Australia, *International Review of Finance,* 18:3, pp.379-409.
G. Truong and G. Partington, 2006, *The Value of Imputation Tax Credits and Their Impact on the Cost of Capital*, Accounting and Finance Association of Australia and New Zealand Conference, Wellington.
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K. Woodward and G. Partington, 2017, *The Price Effects of Australian Structured Share Buybacks*, 15th INFINITI Conference on International Finance, Valencia.
E. Lai, A. Ainsworth, M. McKenzie, and G. Partington, 2014, *The Value of Dividends: Evidence from Short-Sales*, Proceedings of the European Financial Management Association 2014 Annual Meetings, Rome.

companies so affected will rise. As discussed above this is likely to be a particular problem for growth stocks, which seems to be a perverse outcome.

Debt financing effects

Under the imputation tax system, the tax advantage of using debt is greatly reduced. Thus, under imputation companies raise less debt finance and equity raising increases. This is the case for Australia and more generally for countries that have had imputation tax systems.[6] The current proposals for legislative change will tend to increase the usage of debt and reduce equity issues, hence increasing company leverage. There are several reasons for this. If a company wishes to pay dividends using external funding the safest way to do this, in terms of avoiding an unfranked classification, is to use debt. Dividend paying companies may be less willing to use equity issues, even for investment purposes, because of the risk that the issue may be classified as funding dividends. The more so if the cost of equity capital increases. The issue of debt and the use of debt interest payments to shield income from corporate tax also becomes more attractive, relative to investors recovering corporate tax through franking credits.

Tax avoidance effects

Under the imputation system corporate tax paid by the company can be recovered by investors through franking credits. Consequently, managers have less incentive to adopt tax avoidance strategies. From the shareholders' point of view, the good news that corporate tax payments have been reduced is accompanied by the bad news that there will be fewer franking credits available for distribution. However, not all franking credits are distributed and of those credits distributed not all get to be used. Because of this wastage of credits, there is still some incentive for tax avoidance, but much less than under a classical tax system.

Both anecdotal evidence and the research evidence is that tax avoidance has diminished as a consequence of the imputation tax system.[7] However, if the wastage of franking credits increases significantly, either by dividends being classified as unfranked, or by becoming locked up in companies, then the incentive for corporate tax avoidance becomes greater. Thus, the proposed changes may lead to increased use of tax avoidance strategies. The increased tax avoidance could be such that the budget gain from the changes is offset by the

[6] See: G. Twite, 2001, Capital Structure Choices and Taxes: Evidence from the Australian Dividend Imputation System, *International Review of Finance,* 2, pp. 217-234.
J. Cohn, S. Titman and G. Twite, *Capital Structure and Investor-Level Taxes: Evidence from a Natural Experiment in Europe*, University of Melbourne, Department of Finance Working Paper, 05/20.
[7] See: R. McClure, R. Lanis, P. Wells and B. Govendir, 2018, The impact of dividend imputation on corporate tax avoidance: The case of shareholder value, *Journal of Corporate Finance*, 48 pp.492-514.
E. Li and A. Tran, 2019, The Australian dividend imputation system and corporate tax avoidance, *Australian Tax Forum*, 34 pp. 357-399.

losses from tax avoidance. Indeed, the costs of tax avoidance might substantially outweigh any gains from the changes proposed.

For tax avoidance to increase what matters is expectations. If managers and shareholders expect significant increases in the wastage of franking credits, then that will be sufficient to increase the motivation for tax avoidance. Why take the risk of franking credits being unusable if that risk can be eliminated by not paying the corporate tax in the first place? This illustrates an important point, what matters is not just what is intended by the proposed changes in the legislation, but also what the market expects.

Effect on dividend distributions

The introduction of the imputation system not only increased the level of dividend payouts by companies it also increased dividend initiations, that is non-dividend paying companies starting to pay dividends.[8] The net effect of the proposed changes on dividend distributions is difficult to assess because the effects are likely to differ across firms. On the one hand some companies may lift their dividends in order to create a higher benchmark for their established practice. On the other hand, some companies may defer dividends rather than lose the associated franking credits. Also, for companies increasing their tax avoidance, there will be fewer franking credits created and thus less incentive to pay high dividends. With respect to dividend initiations, some companies may initiate dividends sooner in order to quickly build an established practice. Other companies may defer initiations in order to avoid the loss of franking credits, waiting until the company can fund the dividend without raising equity.

Conclusion

The expected revenue impact of the proposed change is given in the explanatory memorandum as $10 million per year. As a consequence of the proposed change there are risks of less investment in Australia and hence less employment, a higher cost of capital, higher corporate leverage, increased tax avoidance, and handicapping of growth stocks and small companies. These effects are clearly undesirable. The magnitude of the effects is difficult to assess since they will depend on the implementation of the legislation, the expectations of managers and investors, and their behavioural response to those expectations. Perhaps the effects will be very small, but there is a clear risk of substantial adverse outcomes and losses to revenue that exceed the gain. In the context of the budget, $10 million is very small beer. Is this revenue gain worth the risks?

[8] See: K. Pattenden and G. Twite, 2008, Taxes and dividend policy under alternative tax regimes, *Journal of Corporate Finance*, 14(1), pp. 1-16.