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MEASURES TO PREVENT TRADING IN FRANKING CREDITS

Financial Implications ($m)

1997-98	1998-99	1999-00	2000-01
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† The measure will protect the revenue base used for the forward estimates, by removing opportunities for significant future expansion of tax minimisation practices. In the absence of the measure, to the extent that the revenue base would not be protected, there would be a significant revenue loss compared to the forward estimates.
‡ The measure will result in unquantifiable revenue gains to the extent of existing tax minimisation.

Explanation

The Government has decided to introduce measures to address trading in franking credits and misuse of the intercorporate dividend rebate provided under section 46 of the *Income Tax Assessment Act 1936* (ITAA).

The underlying principles of the imputation system as introduced in 1987, and as reflected in its affordability, include: first, that tax paid at the company level is in broad terms imputed to shareholders proportionately to their shareholdings; and second, that the benefits of imputation would be available only to the true economic owners of shares, and only to the extent that those taxpayers were able to use the franking credits themselves.

The amendments to address trading in franking credits and misuse of the intercorporate dividend rebate are designed to restore the second underlying principle of the imputation system and address schemes in which shareholders are able to fully access franking credits without bearing the economic risk of share ownership. In such arrangements, the taxpayer to whom the benefits are transferred generally claims a tax deduction for amounts paid to other taxpayers in relation to the transfer of benefits. This is in addition to the franking rebate received by the shareholder under the existing dividend imputation arrangements. Similar arrangements can be entered into to gain advantages from the intercorporate dividend rebate.

Arrangements that allow franking credits to be transferred, by separating legal ownership from the economic risks of share ownership, undermine this principle by allowing the full value of franking credits to be accessed without bearing the economic risk. To allow such arrangements to continue would bring into question the affordability of the imputation system as originally designed.

Amendments to address schemes which undermine the first underlying principle are set out in the separate Treasurer’s Press Release on ‘Measures to Prevent Dividend Streaming’.

The Government intends to introduce amendments to the ITAA to:

- **limit the source of franking credits available for trading** by denying franking credits to, and cancelling the existing franking surpluses of, companies that effectively are wholly owned by non-resident shareholders or tax exempt shareholders (including the Commonwealth and State and Territory governments);
  - arrangements will be put in place to ensure that non-resident shareholders in such companies receiving franked dividends will continue to be exempt from dividend withholding tax;
- **prevent short-term franking credit trading** by denying franking credits and the intercorporate dividend rebate on dividends paid to holders of shares where the taxpayer acquires shares or interests in shares and then disposes of them (or equivalent shares or interests) within 45 days (or 90 days in the case of preference shares) and during this period dividends are payable or the taxpayer enters into a risk-reduction arrangement within 45 (or 90) days of the time of acquisition of the shares or interests;
- **prevent longer-term transfer arrangements** where franking credits and the intercorporate dividend rebate are received by taxpayers who are not carrying the economic risks and benefits of share ownership by denying franking credits and the intercorporate dividend rebate on dividends where the taxpayer (or an associate) is under an obligation to make related payments with respect to positions in substantially similar or related property; and
- **provide for a general anti-avoidance rule** against franking credit trading and streaming, to apply to arrangements where one of the purposes (other than an incidental purpose) is to obtain a tax advantage in relation to franking credits.

The intent of these measures is broadly consistent with elements of measures that operate in a number of other countries (eg New Zealand and the United States) relating to the tax treatment of dividend payments.

The general anti-avoidance rule will apply to deny franking credits on dividends and other distributions paid on or after 7.30 pm AEST, 13 May 1997, including those relating to arrangements entered into before the date of announcement.

The measure to prevent companies effectively wholly owned by tax exempt and non-resident shareholders from holding and accruing franking credits will apply from 7.30 pm AEST, 13 May 1997 subject to the transitional provisions explained in the attachment. The remaining rules will apply to dividends and other distributions paid on shares and interests acquired, and arrangements entered into, on or after that time.

Details of the amendments are provided in the attachment.

The above material is an extract of the description of the measure as contained in *Budget Paper No 2: Budget Measures 1997-98*. This paper explains all outlays and revenue measures, and is available from Australian Government Bookshops or from the Treasury Internet site at http://www.treasury.gov.au/budget

CANBERRA
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ATTACHMENT

Limiting the Source of Franking Credits Available for Trading: Cancellation of Franking Accounts of Companies Wholly Owned by Non-Residents or Tax Exempts

Companies Subject to this Measure

This measure will apply to companies that are effectively wholly owned by:

- non-residents; and/or
- tax exempt bodies (eg exempt State and Commonwealth bodies).

If there is a chain of wholly owned companies, this measure will apply to each company in the chain if the holding company is within the measure.

For the purposes of determining ownership immaterial shareholdings, dividend access shares, converting preference shares, finance shares and shares which do not carry dividend entitlements will be ignored. Therefore, if, for example, an Australian subsidiary of a non-resident company is wholly owned by the non-resident parent company except for an immaterial number of shares held by, say, resident directors, the subsidiary company would be subject to this measure. The legislation implementing this measure will also provide for the disregarding of shareholdings issued for the purpose of avoiding the application of the measure.

Cancellation of Existing Franking Surpluses and Establishment of Exempting Account

If a company subject to this measure has a franking surplus as at 7.30 pm AEST, 13 May 1997 that surplus will be cancelled. Franking deficits will be unaffected.

In place of the cancelled franking surplus the company will create a surplus of the same amount in an equivalent exempting account. For example, a company subject to this measure with a $1 million class C franking surplus and a $100,000 class A franking surplus will, from 7.30 pm AEST, 13 May 1997, have a class C exempting account surplus of $1 million and a class A exempting account surplus of $100,000.

The exempting account will operate in the same way as a franking account to the extent that companies will be required to ‘frank’ their dividends with exempting credits just as they currently frank dividends with franking credits according to the required franking rules. Non-resident shareholders receiving a dividend franked with an exempting credit will be relieved from dividend withholding tax to the extent that they would have been so relieved had the dividend been an ordinary franked dividend. Thus non-resident shareholders will continue to receive the benefit of franked dividends by way of an exemption from withholding tax. However, a dividend paid to a resident which is franked with exempting credits would not carry an entitlement to any franking credits or franking rebates, unless it is paid to a company in the same wholly owned group as the company paying the dividend, in which case the recipient company will credit its exempting account by the amount of exempting credits attached to the dividend. Tax exempt shareholders will be unaffected by the receipt of such dividends because, like ordinary franked dividends, the dividends will be exempt.

A deficit in the exempting account at the end of a franking year would incur the same taxes and penalties as an equivalent deficit in a franking account (ie franking deficit tax and, where applicable, franking additional tax). However, for companies that cease to be wholly owned by tax exempts or non-residents and therefore maintain both a franking account and an exempting account (see below), a deficit in the exempting account at the end of a franking year will be able to be offset by a franking surplus so that equivalent franking deficit tax and franking additional tax would only be payable if the deficit in the exempting account exceeds the surplus in the franking account. A franking deficit, on the other hand, will not be able to be offset by a surplus in the exempting account.

Companies which become wholly owned by non-residents or tax exempts at a time after 7.30 pm AEST, 13 May 1997 will be subject to this measure from that time.

Future Franking Credits and Debits

Future franking credits and debits that would otherwise arise to a company which is wholly owned by non-residents or tax exempts will be posted to the relevant exempting account rather than the franking account. For example, if the company pays $360,000 tax and then pays a $100,000 frankable dividend (which would be franked with exempting credits), it would first post a $640,000 credit to its class C exempting account and then a $100,000 debit.

Companies Ceasing to be Wholly Owned by a Tax Exempt or Non-Resident

Companies which cease to be wholly owned by non-residents or tax exempts will be required to re-establish a franking account. However, they will also retain their exempting account and post to that account credits and debits representing amounts that would otherwise be franking credits and franking debits attributable to the period, or to an event taking place, before the time it ceased to be wholly owned. For example, suppose the company which in the previous example paid $360,000 tax was sold to a taxable Australian resident and, after the change in ownership, it received a refund of the tax paid. Instead of posting a franking debit to its re-established franking account, the company would post a debit of $640,000 to its exempting account. Similarly, if the company pays an amount of tax attributable to a period before the change in ownership, the resulting credit arising from the tax payment would be posted to the exempting account and not the franking account.

If a company ceased to be wholly owned by non-residents because part, but not all, of the non-resident shareholding was sold to a taxable Australian resident, the company would be able to distribute a surplus in its exempting account by way of a dividend franked with exempting credits to the continuing non-resident shareholders (to provide an exemption from dividend withholding tax), but only after the company had exhausted its franking surplus. While the company has a franking surplus, all dividends paid will have to be franked with franking credits according to the required franking rules regardless of whether the dividend is paid to a non-resident or resident.

Special transitional arrangements may apply to the sale of Commonwealth owned companies.

Transitional Provisions

Transitional provisions will apply to ensure that resident taxpayers are not disadvantaged where, before announcement of this measure, they have entered into a contract to purchase a company from a non-resident or tax exempt and the price negotiated reflects the availability of a franking surplus.

These transitional provisions will apply where, before 7.30 pm AEST, 13 May 1997, a taxable resident has become contractually obliged to purchase a company wholly owned by non-residents or tax exempts. Provided that acquiring the franking credits of the company was not a purpose (other than an incidental purpose) of the acquisition of the company, this measure will not apply to the company.

Preventing Short-Term Franking Credit Trading: Introduction of a Holding Period for Shares

This measure denies franking credits (and therefore any franking rebate) and the section 46 intercorporate dividend rebate on dividends paid on shares, and distributions paid on an interest in shares (eg distributions of franked dividends to the beneficiary of a trust), where the shares or interest are not effectively held for more than 45 days (or, for preference shares, 90 days). It applies in relation to shares and interests acquired on or after 7.30 pm AEST, 13 May 1997, unless the taxpayer had become contractually obliged to acquire the shares or interest before that time.

The measure applies where a taxpayer acquires shares or an interest in shares and:

- the taxpayer effectively holds the shares or interest for 45 days or less (ordinary shares) or 90 days or less (preference shares, defined below); and

- during this period a dividend is payable on the shares, or a distribution is payable on the interest in the shares, so that the taxpayer would, but for this proposed amendment, be entitled to franking credits or the section 46 intercorporate dividend rebate (or both) in respect of the dividend or distribution.

For these purposes, a taxpayer will have effectively held the shares or interest for less than the relevant period if, within the period:

- the taxpayer disposes of the shares or interest; or

- the taxpayer disposes of substantially identical securities (defined below); or

- an associate (see below) of the taxpayer disposes of such substantially identical securities and the acquisition by the taxpayer and the disposal by the associate is under an arrangement; or

- in the case of a company taxpayer, another company in the same wholly owned group disposes of those substantially identical securities.

For the purposes of calculating the 45 day or 90 day period, any period or periods during which the taxpayer has a diminished risk of loss of holding the shares or interest (see below) will be disregarded. However, a diminished risk of loss will not count for these purposes unless the risk of loss has been materially diminished. Generally, if changes in value of a share are offset by changes in value of a derivative by an amount greater than 70 per cent, there would be a materially diminished risk of loss.

For these purposes the day of disposition, but not the day of acquisition, will be counted, and any day more than 45 days after the date the share or interest becomes *ex-dividend* will be disregarded.

Example

A taxpayer buys shares on 1 July 1997. On 2 July 1997 the taxpayer buys share price index (SPI) futures, thereby diminishing the risk of holding the shares. It is anticipated that the SPI futures will increase in value by an amount equal to 85 per cent of any fall in the value of the shares. On

1 September 1997 the shares go *ex-dividend* and a franked dividend is subsequently paid to the taxpayer. At the close of business on 1 October 1997 the SPI futures are closed out, and the taxpayer thereafter holds the shares at risk until 31 December 1997, when the shares are sold.

The taxpayer is not entitled to a franking credit, franking rebate or the intercorporate dividend rebate because the taxpayer entered into a risk reduction arrangement within 45 days of acquiring the shares and shares are held at risk for only 15 days before the 46th day after the shares went *ex-dividend*.

Preference Shares

For the purposes of this measure, preference shares are shares which:

- have a fixed dividend entitlement or which, having regard to the terms of their issue, are likely to have a fixed dividend return; or
- having regard to the terms of their issue or other relevant matters, are less risky than ordinary shares.

Substantially Identical Securities

Substantially identical securities will be defined to be any economically equivalent property whose value is linked to the share in question.

Economically equivalent property would include:

- other shares in the same company (including shares of a different class where there is no material difference between the classes, or shares which are exchangeable into shares of the type bought);
- shares in another company, or an interest in a trust or partnership, whose only assets are shares of the type bought;
- convertible notes whose price correlates with the share price; or
- any other non-traditional securities (eg debt-equity hybrid instruments) whose value correlates with the price of the shares.

Associate

An associate will be defined to include relatives of the taxpayer and entities controlled by the taxpayer. Where two entities are under common control (including where one of the entities is the taxpayer), those entities will also be treated as associates of each other.

Diminished Risk of Loss

For the purpose of calculating how much of a holding period is to be disregarded because of a diminished risk of loss, if there is an arrangement under which the taxpayer or an associate (see above) can or will effectively dispose of the shares or interests (or substantially similar or related property, see below) the period during which the arrangement was in effect will be taken to be a period of diminished risk. Therefore, if shares or an interest in shares are acquired with such an arrangement in place which remains in effect, the measure will apply in relation to those shares or interest to deny the franking credits and intercorporate dividend rebate.

Such an arrangement will exist if the taxpayer:

- has an option to sell (see below), a contractual obligation to sell at a future date or makes a short sale of the shares (or substantially identical securities, defined above); or
- grants an option to buy the shares (or substantially identical securities) which diminishes the risk of loss (see below); or
- has diminished the risk of loss by holding one or more other positions with respect to the shares or substantially similar or related property (see below): a taxpayer will have diminished risk of loss for these purposes if changes in the market value of the shares and the positions are reasonably expected to vary inversely.

The Australian Taxation Office will hold early consultations with interested parties on the implementation of this aspect of the measures.

Substantially Similar or Related Property

The question of whether property is substantially similar or related property will be determined according to the facts and circumstances of each case. In general, property will be substantially similar or related to shares if:

- the market value of the shares and property primarily reflect the performance of:
  - — a single company or enterprise;
  - — the same industry or industries; or
  - — the same economic factor or factors (eg interest rates, commodity prices or foreign currency exchange rates); and
- changes in the market value of the shares are reasonably expected to approximate, directly or inversely, changes in the market value of the property.

Options

In relation to the writing of options to buy shares, the risk of loss will have been diminished for the purposes of this measure if the option is likely to be exercised or closed out at a profit. If, for example, a collateral arrangement exists to ensure that the option to buy will be exercised, or there is a ‘deep-in-the-money’ call option (where the exercise price is much lower than the market value of the shares when the option is written), the option will have insulated the shareholder from risk and the proposed measures will apply to deny the franking credits and intercorporate dividend rebate.

In relation to the buying of options to sell shares, an option which is not likely to be exercised or closed out at a profit will not, by itself, diminish the risk of loss for the purposes of this measure. For example, a ‘deep-out-of-the-money’ put option will generally not constitute a diminution of the risk of holding shares.

Shares Held on Trust

If a taxpayer has an interest in a trust which holds shares on which, within the relevant period of acquisition (see above), the risk of loss has been diminished, the franking credit and intercorporate dividend rebate attaching to distributions received from the trust will be denied because the taxpayer has effectively acquired an interest in shares on which the risk of loss has been diminished.

Circumstances will arise, however, where the trust holds the shares at risk for the 45 or 90 day period (whichever is applicable) but then puts in place a risk diminution arrangement before the beneficiary acquires an interest in the trust. In such cases the beneficiary has a diminished risk of loss in relation to those shares even though the trust itself has held the shares for the requisite period. Provided it is practical to trace a particular trust distribution paid to the beneficiary to those shares, a 'look through' approach will be adopted and the franking credits and intercorporate dividend rebate will be denied on the trust distributions. In closely held trusts this look through approach would be possible. For these purposes a trust is closely held if a beneficiary has, or up to 20 beneficiaries (not counting associates) have between them, for their own benefit, fixed entitlements (held directly or indirectly) to a 75 per cent or greater share of the income or capital of the trust.

However, it is recognised that for widely held trusts it is difficult to apply a look through approach because ultimately it would be necessary to trace the receipt of a particular distribution from the trust to a particular dividend. Therefore the look through approach will not be adopted for trusts which are not closely held (as defined above). As a result, beneficiaries in public unit trusts will not be required to adopt the look through approach in relation to distributions received on their units.

If the beneficiary has put in place an arrangement within 45 days to eliminate the risks of holding the interest in the trust (as opposed to the shares themselves), that will be treated in the same way as a shareholder diminishing the risk of holding shares. Therefore, even in a public unit trust, franking credits and the intercorporate dividend rebate on trust distributions will be denied if such an arrangement is in place.

Example

(a) A trust, established in 1990 with five beneficiaries entitled to share equally in trust property, holds shares in Company A and Company B acquired at the time of its establishment. In June 1997 the trustee appoints a sixth beneficiary, who shares in the trust property equally with the original beneficiaries. At the same time the trust buys a put option over the shares in Company A so that there is a diminished risk of loss of holding them. The trust then acquires shares in Company C which, at the time of acquisition, are subject to put options so that there is a diminished risk of loss of holding them.

    None of the beneficiaries will be entitled to franking credits or the intercorporate dividend rebate in relation to distributions attributable to dividends paid on Company C shares. The original five beneficiaries will continue to be eligible for franking credits and the intercorporate dividend rebate in relation to dividends paid on Company A and Company B shares. However, the new beneficiary will be so entitled only in relation to dividends paid on Company B shares. It would therefore be necessary for the trust to determine how much of a distribution to the sixth beneficiary is attributable to the dividends paid on the Company B shares. For these purposes an attribution on a reasonable basis will be acceptable.

(b) Taxpayers A and B acquire units in a public unit trust which pays a franked distribution five days later. Taxpayer A continues to hold the units for over 45 days, while Taxpayer B disposes of the units within 45 days. The trust, which had held the shares at risk for more than 45 days, disposed of them immediately after it paid the franked distribution.

Even though some of the trust distribution may be attributable to shares which were not held at risk by the beneficiaries for 45 days (because of the disposal by the trust immediately after acquisition of the units), it is not necessary for the distribution to be traced to those particular shares because the trust is not a closely held trust. Therefore Taxpayer A will be entitled to the franking credits on the distribution. However, Taxpayer B has disposed of the units within the specified time and therefore will not be entitled to the franking credits or intercorporate dividend rebate.

Preventing Longer-Term Transfer Arrangements: Introduction of a Related Payments Rule for Dividends

This measure denies franking credits (and therefore any franking rebate) and the intercorporate dividend rebate on dividends paid on shares, and on distributions paid on an interest in shares (eg distributions of franked dividends to the beneficiary of a trust), where the taxpayer effectively has no interest in the dividend or distribution because of an obligation to pass it (or an equivalent payment) to another taxpayer. It applies in relation to arrangements entered into on or after 7.30 pm AEST, 13 May 1997.

The measure applies where:

- a taxpayer would, but for the application of this measure, be entitled to franking credits or the intercorporate dividend rebate (or both) in relation to a dividend or distribution paid on shares or an interest in shares; and

- the taxpayer or associate (as defined above) is under an obligation to make related payments (explained below) with respect to positions in property which is substantially similar or related to the shares or interest (substantially similar or related property is defined above).

Obligation To Make Related Payments

An obligation to make related payments would include an obligation to make payments equivalent to dividend payments as and when the dividends are received or at some later time. An example would be an obligation to pay interest on an instrument whose value correlates with the shares on which the dividends are paid. It would also include crediting of those payments to another person. For example, share warrant arrangements under which the warrant holder effectively borrows money from the issuer and relies on future dividend payments to pay off the effective loan, will generally be subject to the related payments rule because, when a dividend is received, there is a notional crediting to the warrant holder of the dividend amount.

Trust Distributions

In calculating the net income of a trust estate, the obligation of the trustee to distribute the dividend to its beneficiaries would not of itself be a related payment for the purposes of this rule. If, however, a trustee was obliged also to make a payment corresponding with the dividend which it has distributed (which could include a distribution to another beneficiary) the rule may apply.

General Anti-Avoidance Rule for Franking Credit Transfer and Streaming Arrangements

A general anti-avoidance rule will apply to deny franking credits (and therefore any franking rebate) on dividends or distributions paid on or after 7.30 pm AEST, 13 May 1997 under certain arrangements having a purpose (other than an incidental purpose) of obtaining a tax advantage in relation to franking credits where the Commissioner makes a determination that such an arrangement exists. The rule will apply even if the payment of the dividend or distribution is made under an arrangement entered into before that time. For example, dividends paid on shares acquired for the purpose of acquiring franking credits which, but for the fact that the shares were acquired pursuant to a binding obligation entered into before 7.30 pm AEST, 13 May 1997, would have been subject to the 45 day rule explained above, may nevertheless be denied the franking credits and intercorporate dividend rebate under this general anti-avoidance rule.

The rule will apply where:

- there is an arrangement for the issue, sale or other disposition of shares or an interest in shares (which, for these purposes, would include making a taxpayer a beneficiary of a discretionary trust holding shares);
- a dividend was payable or expected to be payable on the relevant shares, or a distribution was payable or expected to be payable on the relevant interest;
- the dividend or distribution was expected to have franking credits attached;
- it could reasonably be expected that any party to the arrangement will, as a result of the arrangement, obtain a tax advantage in relation to franking credits, being the obtaining of a franking rebate to offset income tax liabilities or a credit to a franking account, or that a party to the arrangement will not be able to obtain such a tax advantage; and
- the obtaining of the tax advantage was not an incidental purpose of the arrangement.

For an arrangement to exist, the issue, sale or disposition of shares and the purpose, not being an incidental purpose, of obtaining a tax advantage for one of the parties to the arrangement must be connected in some way.

Factors relevant in determining the existence of a purpose (other than an incidental purpose) of obtaining a tax advantage in relation to franking credits would include:

- the length of time the interest or shares are held at risk by the party benefiting from the franking credits (the shorter the time, the more likely the transaction is for franking credit trading purposes);
- the tax profiles of the parties (eg the person who, but for the arrangement, would have received the franking credits may have been unable to make full use of the franking credits, whereas the person who, because of the arrangement, does receive the franking credits may be able to fully use them);
- the consideration paid in relation to the arrangement by or on behalf of the party benefiting from the franking credits (ie whether it is calculated by reference to the franking benefit obtained); and

- the degree of risk to which the party benefiting from the franking credits is exposed to (the greater the risk, the less likely there is a franking credit trading arrangement).

Having regard to these factors and to the requirement for the purpose of obtaining a tax advantage to be more than an incidental purpose of the arrangement, the mere acquisition of shares by an arm’s length dealing on the stock market, where the shares are to be held at risk in the ordinary way, would not, in the absence of further features, attract the rule, even though the shares are expected to pay franked dividends.

Where the Commissioner makes a determination that the rule applies, as an alternative to denying the franking credits on the dividends, the determination may require a debit to the franking account of a company that is party to the arrangement.