The Franking Credits Policy Horse Race

The Government currently has two horses running in the race to prevent the corruption of the dividend imputation system by smart investment banks and financial advisers. One is a real nag and, although draft legislation has been produced, should never have been allowed to enter the race. The other is not a favourite of the smart money punters who stand to lose – to the benefit of all others, but is a thoroughbred of solid pedigree and will hopefully emerge victorious.

The ”nag” is the proposal to prevent companies raising funds via equity issues to fund a near-simultaneous franked dividend payment. As well as being of dubious pedigree, the proposal to backdate its application to the date of its first mention in the 2016 MYFEO is causing a lot of anguish. Why the government is thinking of pursuing this proposal for an estimated tax saving of $10 million p.a. beggars belief!

The ”thoroughbred” is the budget proposal to align the treatment of off-market buybacks with on-market buybacks, by preventing companies from including franked dividends as part of the payment made to participants in the buyback. This is expected to save around $0.5 billion p.a. in tax revenues – prize-money worth fighting for – and would end the unfair and inequitable treatment of most shareholders arising from these buybacks.

The proposal to prevent companies raising cash equity issues to fund a franked dividend payout (the “nag”) has no economic logic to it. A company may have accumulated a stock of franking credits from tax paid on past profits, which it has not previously paid out as dividends due to the need to use the cash involved for other profitable investments. It may currently have insufficient cash on hand to pay a dividend which is franked using the stock of accumulated credits, to reward deserving shareholders, even though it is solvent and profitable and legally allowed to pay a dividend.

Internationally it is quite common practice for companies to fund payouts with debt and/or equity issuance. For example, in the U.S. over 40% of companies that make payouts also raise capital in the same year, mostly using debt (see here). Equity issues are used less frequently to fund payouts in the U.S. because in a classical tax system the tax-deductibility of interest payments makes debt more preferable to equity finance than in an imputation tax system. Companies in other jurisdictions frequently use the capital markets to simultaneously make payouts and raise capital, and in this manner jointly manage their cash position and their preferred leverage.

The practicalities of the proposal are also problematic. How would the ATO determine when the prohibition should be applied – would an equity capital raising six months separate from the dividend payment be OK or not? A serious anomaly arises because debt issues are not included in the draft legislation, so presumably companies could fund the payout by borrowing and then at some later date, issue equity to retire the debt. Why put the ATO in the position of having to make such arbitrary determinations?

How would the legislation be applied to banks and other financial institutions which are continuously raising quasi-equity finance in the form of Additional Tier One and Tier 2 capital (preference shares which can convert into equity)? How about if a company made a convertible debt issue which would later convert into equity? What about if a company initiated a dividend reinvestment scheme, thereby raising new equity finance to partially fund the dividend payout? What logic could be used to exempt such cases?

And the proposal to back-date application of the proposal, even though the measure had been signalled in 2016, would create all manner of administrative problems in reversing past tax positions of investors who received franked dividends from the now illegal transactions. A huge amount of angst is already apparent from the announcement of the proposal (although the Treasury/Treasurer, as usual, is very slow in releasing submissions to the consultation. Our submission can be found here). And for a mere $10 million p.a. of tax revenue savings!

This horse certainly needs to be scratched from the race!

The "thoroughbred" proposal, on the other hand, has merit on grounds of both economics and equity. Even ignoring the significant tax gains likely, these Tax-Driven-Off-Market-Buybacks (TOMBs, as we have called them), are unfair to those shareholders who do not participate. (There have only been around sixty to date, but of immense size, by large companies). As in many situations, the gains to a few are clear and conducive to lobbying, but the significant cost to the majority is less apparent. In the case of TOMBS, the non-participating shareholders are not compensated adequately for the "streaming" of franking credits to the zero and low-tax-rate participating shareholders.

We have outlined the reasons for the inequity here.

We have also explained in an article in the Pearls and Irritations public policy journal that there is no reason as to why TOMBs should be allowed by the regulators, and that there is no apparent adequate justification for the ATO and ASIC permitting them to happen. The approval of these highly structured, artificial, financial transactions reeks of regulatory capture. In the absence of TOMBs, if a company wants to distribute excess franking credits, it can pay a special dividend. If it wants to return capital to shareholders it can do so via a normal share buyback.

Somehow, in the mid-1990s, the smart money managed to get the regulators to acquiesce to allowing TOMBs with their artificial structure which streams franked dividends to a subset of lucky shareholders at the expense of other shareholders and government tax revenue.

Hopefully the thoroughbred will stay the course and win the race - leading to the banning of TOMBs - and not get nobbled by lobbyists. That would further strengthen the case for scratching the “nag”.

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