Let's be Frank about Franking Law Changes

The non-informatively named Treasury Laws Amendment (2023 Measures No. 1) Bill currently being considered by Parliament is a mish-mash of good and bad. That reflects the process of its development through Treasury consultations.

Schedules 4 and 5 of the Bill are concerned with companies distributing franking credits. Schedule 4 is good, Schedule 5 is bad, although the opposition has proposed an amendment that both should be deleted (even though Schedule 5 had its genesis under the Morrison government).

Schedule 4 effectively would prevent companies from using Tax-driven, Off Market Buybacks (TOMBs) to stream franking credits to zero and low tax rate shareholders. As well as creating a significant loss to government tax revenue from such streaming, TOMBS involve significant shareholder inequities. Moreover, the returns of capital and payment of franked dividends involved can be achieved by more standard and equitable capital management techniques rather than these highly structured, complex transactions.

Our previous research estimated a tax cost of TOMBS exceeding $1 billion in some years (it depends on how many are done and how large they are, since it is only a small number of large companies involved). Treasury provides an estimate of $550 million per year of tax savings.

The legislation and accompanying explanatory material focuses on the tax cost to the budget. That alone warrants the legislation preventing franked dividends being part of an off-market buyback – it also makes any future buybacks more consistent with international practice. The inequitable treatment of shareholders is at least as important a reason as to why TOMBS deserve to die and be assigned to the graveyard of prohibited tax-rorts.

Schedule 5 aims to prevent companies from paying franked dividends if they appear to be at variance with their "usual" dividend practices and are financed by near-simultaneous equity raisings. This is just silly! Companies may have undistributed franking credits due to taxes paid in the past when financial management priorities led them to not pay dividends and instead use that cash for funding profitable investments.

Later, payment of a franked dividend may be optimal for investor relations or other reasons, but if no free cash is available, a capital raising may be required to obtain cash.

Note that such a capital raising could involve a debt or equity issue, but it is only the latter that is targeted in the proposed legislation. This reflects an apparent concern that an equity issue might be reflecting tax avoidance activities. Arguably that could be so, but there has been no public information provided of relevant examples.

When first mooted in the 2016 MYEFO, it was suggested that such practices might involve a cost to revenue of (only) $10 million pa. This complicated piece of legislation requires the ATO to arbitrate on which of a company's interactions with the capital market to manage capital structure are allowable. By creating uncertainty it would hinder the efficiency of corporate capital market funding. To do so for such small tax beer seems, to say the least, silly.

The process by which the proposed legislation has come to this point also warrants attention. Treasury, as is common, held consultations on draft legislation. Regarding the schedule 5 topic, the first consultation concluded on October 2022. Submissions received from the public are still not available on the Treasury website. Likewise, submissions on the consultation on the Schedule 4 topic (Improving the integrity of off-market share buy-backs) which concluded in December 2022 are still not available.

Surely a consultation process is not just for Treasury or its masters to get feedback. Ignoring those submissions which contradict its opinion without exposing competing views to the sunlight of public debate is unacceptable. Where there are competing views between various vested interests and independent analysts, good public policy decision-making deserves public exposure of the arguments and views of those seeking to influence public policy.

That is also relevant for the process of Parliamentary scrutiny of legislation. Members and Senators (and their staff) should not be expected to make decisions on Bills based solely on Explanatory Memoranda – which naturally don't include the counter-arguments to what is being proposed. Ability to access non-confidential submissions made in the consultation process can help determine whether lobby groups and others seeking to influence votes are simply talking their own book or reflect more widely-held opinions.

In our view, Section 4 (prohibiting TOMBs) warrants support, Section 5 (interfering with corporate interactions with the capital markets) warrants rejection.

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