

Senate Economics Legislation Committee

New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002

Submission No. 1

Submittor: Australian Bankers' Association
Mr Bavid Bell
Chief Executive Officer
Level 3
56 Pitt Street
SYDNEY NSW 2000

Telephone: 02 8298 0401

Facsimile: 02 8298 0447

EMAIL:

Attachments? No Attachments



AUSTRALIAN BANKERS' ASSOCIATION

David Bell
Chief Executive Officer

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0401
Facsimile: (02) 8298 0447

04 November 2002

Dr Kathleen Dermody
The Secretary
Senate Economics Legislation
Committee Room SG.64
Parliament House
CANBERRA ACT 2600



Dear Dr Dermody,

**Submission on New Business Tax System
(Consolidation and Other Measures) (No 1) Bill 2002**

Purpose of this submission

We refer to the Senate's invitation for written submissions on the abovementioned Bill.

The purpose of this submission is to request that two relatively small but important drafting changes be made to proposed section 215-25 of the *Income Tax Assessment Act 1997*. This section is to be introduced by item 4 of Schedule 17 of New Business Tax System (Consolidation and Other Measures) (No 1) Bill 2002 ("the Bill").

Proposed sections 215-15, 215-20 and 215-25 are intended to replace, with no material changes of meaning, provisions that are currently contained in section 160APAAAB of the *Income Tax Assessment Act 1936*. This will consolidate all of the imputation provisions within the same area of the *Income Tax Assessment Act 1997*.

Section 160APAAAB was seriously defective from the outset, but the errors have only recently been identified.

The defects in section 160APAAAB have been carried over to proposed sections 215-15, 215-20 and 215-25. In particular, two of the provisions in section 215-25 contain obvious errors. The amendments suggested below would correct those errors.

Unless these basic changes are made to proposed section 215-25, the new provisions will simply not have their intended effect. An inappropriate restriction will apply to the payment of franked distributions on instruments that qualify as equity under the debt and equity provisions but are not shares. This will frustrate the operation of a key aspect of the new debt and equity system and will undermine the substance-based (rather than form-based) approach that the debt and equity system aims to introduce.

Although this submission is made by the Australian Bankers' Association ("ABA") on behalf of its members, the defects in the current drafting potentially affect all taxpayers.

Purpose of the provisions

The general policy of the debt and equity provisions is that returns paid on instruments that are not shares but qualify as "equity" (referred to as "non-share dividends") are generally frankable in the same way that dividends on shares are frankable and are not deductible (see paragraphs 2.83 and 2.84 of the Explanatory Memorandum to the Debt and Equity Act).

The purpose of existing section 160APAAAB is to prevent an unfair advantage being obtained by a company issuing instruments that are not shares but qualify as equity for tax purposes, rather than issuing shares, and paying franked returns in cases where a franked dividend could not have been paid because the company had insufficient profits (see paragraphs 2.85 and 2.86 of the EM).

In terms of mechanics, section 160APAAAB (and proposed sections 215-15, 215-20 and 215-25) establishes a formula which limits the "frankable amount" of a distribution on a "non-share equity" instrument. It is clear that Parliament's intention was that the limitation should be calculated broadly as follows:

1. Actual profits immediately before the payment of the non-share dividend; plus
2. Estimated future profits; less
3. Profits required to pay "committed share dividends" (ie dividends on shares).

However, the existing provision and proposed new legislation do not in fact achieve this objective. The key problem is that an entity has to deduct all committed distributions in calculating the frankable amount of a non-share dividend but is not permitted to add expected profits for the same period.

The formula also contains another step that is not relevant to the following discussion.

Suggested Amendments

We outline below the amendments that are required to section 215-25 and the reasons for those amendments.

1. **Proposed amendment to the definition of “available frankable profits”**

The definition of “available frankable profits” in subsection 215-25(1) contains a typographical error.

The definition reads as follows:

“The available frankable profits immediately before the entity pays the non-share dividend are then the amount estimated by the entity, having regard to the expected profits referred to in paragraph (c)”.

The “expected profits” that are referred to in this definition are covered in paragraph (d) of subsection 215-25(1), not in paragraph (c) of subsection 215-25(1).

The error should be corrected by deleting the words “paragraph (c)” in the definition of available frankable profits and replacing it with the words “paragraph (d)”.

2. **Proposed amendment to subsection 215-25(2)**

The formula in subsection 215-25(2) contains an error of logic.

The policy behind being able to include an estimate of future profits in the calculation of the maximum frankable amount is clearly outlined in paragraph 2.90 of the Explanatory Memorandum to the Debt and Equity Act, as follows:

*“In certain situations the calculation of available frankable profits could disadvantage a company. These are where the company has committed itself to paying dividends on shares in the future and expects to derive available profits between the time it committed itself to their payment and the time of payment, and, but for the committed dividends, the company would have been able to frank a non-share dividend. In these cases the company can estimate future profits to the extent it expects them to arise, **provided the estimated profits do not permit the franking of the non-share dividend to an extent greater than would be the case if the committed share dividends did not exist.**” (emphasis added)*

As currently drafted, the formula in subsection 215-25(2) does not work in the manner that the Debt and Equity Explanatory Memorandum intended. As noted earlier, the key problem that makes the definition unworkable is that an entity has to deduct all committed distributions in calculating the frankable amount of a non-share dividend but is not permitted to add expected profits for the same period. A misordering of the provisions in subsection 215-25(2) has the result that expected profits can **never** be added whereas all committed future dividends must be deducted.

This error arises because the limitation placed on adjusted expected profits by paragraph (b) of the definition of “adjusted expected profits” removes the benefit to the entity of being able

to estimate future profits under paragraph (a) of that definition. Because of the “lesser of” formulation used in the definition of “adjusted expected profits”, the amount of “adjusted expected profits” can never exceed the amount of actual distributable profits calculated under paragraph (b). This restriction is inappropriate because the committed distributions have already been taken into account in calculating the “actual available frankable profits”.

The appropriate calculation to give effect to the policy described in the Explanatory Memorandum is:

- to increase actual available frankable profits by the profits that are expected to arise before payment of the committed distributions; but
- to restrict the amount of estimated future profits to the amount of committed distributions (or simply to state that the net effect of deducting committed distributions and adding expected future profits can never increase the available frankable profits above the level of actual current distributable profits).

The following example shows why this approach will not result in a company being able to frank non-share dividends to a greater extent than would be the case if there were no committed distributions.

Example:

A company capitalises a subsidiary by subscribing for a non-share equity interest for \$1,000 and ordinary shares for \$2. The subsidiary raises additional capital of \$1,000 by issuing shares with a term of 5 years which have annual committed distributions of \$100 (ie. \$500 over 5 years). The subsidiary expects to derive available profits of \$200 per annum. At the end of year 1 the subsidiary wants to pay a fully franked non-share dividend of \$100 and has the following:

- Maximum frankable amount (215-20(1)) of \$200;
- Committed share dividends (215-20(1)) and committed distributions (215-25(1)(a)) of \$500 (\$100 per year for the 5 year term of the shares); and
- Undebited non-share dividends (215-20(1)) of nil.

As a result, the available frankable profits (215-20(1)) and actual available frankable profits (215-25(2)) will be negative \$300 (ie. \$200 - \$500). In these circumstances, all of the requirements of subsection 215-25(1) are satisfied and it is consistent with the policy outlined above in paragraph 2.90 of the Debt and Equity Explanatory Memorandum that the subsidiary should be able to estimate its future profits.

The amount calculated for the purposes of paragraph (a) of the definition of adjusted expected profits in subsection (215-25(2)) will be \$800 (ie. \$200 pa for four years). The amount

calculated for the purposes of paragraph (b) of the definition of adjusted expected profits in subsection (215-25(2)) will be \$100, that is, the difference between nil and \$100 (the frankable amount if the committed distributions were ignored). As adjusted expected profits is the lesser of (a) and (b), adjusted expected profits will be limited to \$100.

The addition of actual available frankable profits and adjusted expected profits will still be negative ($(\$300) + \$100 = (\$200)$) and the non-share dividend will not be able to be franked even though the company has a maximum frankable amount of \$200 and sufficient estimated profits to cover the committed distributions. In other words, the subsidiary's actual profits plus estimated profits exceed the aggregate of the non-share dividends and committed distributions and yet the company cannot frank the non share dividend.

If the limitation in paragraph (b) did not apply, the adjusted expected profits would be \$800 and the addition of actual available frankable profits and adjusted expected profits would be \$500. This could potentially result in the company being able to frank non-share dividends to a greater extent than would be the case if the committed distributions did not exist. In that case it would be appropriate to limit the available frankable profits to the amount calculated under paragraph (b), that is \$100, and the subsidiary would be able to fully frank the non-share dividend of \$100.

We suggest that subsection 215-25(2) be amended as follows (note we have only amended the ordering and not the actual wording):

“(2) The amount estimated under subsection (1) must not exceed the lesser of:

(a) Actual available frankable profits + Adjusted expected profits; and

(b) the difference between:

(i) in a case where the single non-share dividend is the only one paid at a particular time—the amount of the non-share dividend that would, apart from subsection (1), be *frankable under section 215-15 and the amount of the non-share dividend that would, apart from subsection (1), be frankable under that section if the committed distributions were ignored; and

(ii) in a case where the non-share dividend is one of a number of non-share dividends made at the same time—the sum of the amounts of the non-share dividends that would, apart from subsection (1), be frankable under section 215-15 and the sum of the amounts of the non-share dividends that would, apart from subsection (1), be frankable under that section if the committed distributions were ignored.

where:

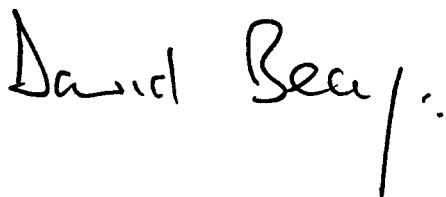
actual available frankable profits is the *available frankable profits the entity would have immediately before paying the *non-share dividend apart from subsection (1).

adjusted expected profits is the available profits that it is reasonable to expect will arise after payment of the *non-share dividend and before payment of the committed distributions.

The application of this proposed amended provision would ensure that in the example above, the correct amount, and only the correct amount of \$100, will be frankable on the non-share equity.

The ABA would be pleased to attend any hearing which the Committee may hold in relation to the Bill.

Yours sincerely,

A handwritten signature in cursive script that reads "David Bell". The signature is written in dark ink and is positioned above a horizontal line.

David Bell