14 February 2014

Ms Maria Noia
Australian Taxation Office
PO Box 9977
Melbourne VIC 3008

Via Email: Maria.Noia@ato.gov.au

Dear Ms Noia,

Draft Taxation Determination TD 2014/D1

The Australian Financial Markets Association (**AFMA**) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We write with respect to the release by the Australian Taxation Office (**ATO**) of Draft Taxation Determination 2014/D1 (**the Draft Determination**), which addresses the question "Can section 177EA of the *Income Tax Assessment Act 1936* apply to a 'dividend washing' scheme of the type described in this Taxation Determination?" The question posed in the Draft Determination is answered in the affirmative.

At the outset, and as is elaborated upon below, AFMA has concerns regarding the approach adopted by the ATO with respect to the practice generically described as "dividend washing." We take the opportunity in this submission to address issues raised specifically in the Draft Determination but also generally with respect to the administration of the law in this area.

AFMA does not endorse dividend washing transactions and indeed was heavily involved in the Treasury consultation process that ultimately led to the creation of the specific integrity rule, effective 1 July 2013, that deems a party engaged in a dividend washing transaction not to be a "qualified person" with respect to the franking credits attached to the second tranche of shares. Our comments should be read in that light.

The Draft Determination

Narrow example underpinning the conclusion in the Draft Determination

The Draft Determination concludes that, based on a very specific set of circumstances, "Section 177EA will generally apply." This set of circumstances sees the holding of shares for a period of at least 45 days prior to the ex-date, the selling of those shares after the ex-date and then re-acquiring the same number of shares in the special market on a cum-dividend basis. Based on the circumstances set out in the Draft Determination, the participant makes a *prima facie* cash loss from the transaction of $200, being the difference between the sale price of the original shares on an ex-dividend basis ($50,000) and the acquisition price of the cum-dividend shares ($51,600) less the cash dividend on the cum-dividend shares ($1,400). In the words of the Draft Determination (Paragraph 9), "without the additional franking credits of $600 attached to the dividends on Parcel B, the trades referred to in Paragraphs 4 and 5 would result in a loss of $200."

This is, in AFMA's view, a very narrow set of circumstances that is perhaps out of step with commercial reality. In reality the investor may be exposed to market risk and other commercial factors at least between the time that the initial tranche of shares are sold and the cum-dividend shares are acquired on the special market, if not over the qualification period for both tranches of shares. In this regard, we note the approach adopted by the ATO in Taxation Ruling TR 2008/1, where a number of examples were canvassed. AFMA advocates that a similar approach should be adopted in the Draft Determination, articulating the ATO's views on issues such as:

- Circumstances where there is a difference between the number of shares sold and then subsequently acquired (or, to use the language from the Assistant Treasurer's Media Release of 28 June 2013, defining what is a "substantially identical membership interest"); and
- Circumstances where there is a gap of, say, a day between the sale of the original shares and the purchase of the cum-dividend shares, particularly where there is substantial movement in the price of the underlying security in the intervening period.

In our view, there needs to be consistency between the approach adopted in TR 2008/1 and that applied in the Draft Determination.

Further, AFMA submits that the ATO should provide an additional example, namely one where the transaction results in a cash profit without taking into consideration the franking credits attached to the second tranche of shares. As the ATO would be aware, a number of investors engage in transactions that seek to exploit arbitrage opportunities in particular markets and this may be extended to pricing anomalies evident in the run-up to and, potentially, after, the ex-date. Consequently, there may be transactions that involve the sale of shares on an ex-dividend basis and the subsequent re-purchase of an equivalent parcel of shares on a cum-dividend basis in the special market that are part of a broader commercial strategy and do not result in a *prima facie* cash loss. It would be appropriate, in AFMA's view, for the ATO to articulate whether a transaction that was commercially explicable without attributing any value to the franking credits on the second tranche of shares would be one to which Section 177EA would apply.

Such an example is particularly important given the comment at Paragraph 27 of the Draft Determination that "the conclusion of purpose can be drawn even if it is clear that the holder also had some other commercial purpose or purposes in entering into the scheme."

It would be helpful for the ATO to articulate its views as to what a "more than incidental purpose" means in this context, potentially with the benefit of this additional example. This is particularly the case given the comments from Gageler J in *Mills v Commissioner of Taxation* where (at Paragraph 66) it was stated that "a purpose can be incidental even where it is central to the design of a scheme if that design is directed to the achievement of another purpose," which in this case would be the derivation of the cash profit.

Application of the seven factors in Subsection 177EA(17)

AFMA holds a number of concerns regarding the manner in which the Draft Determination has sought to apply the relevant circumstances in Subsection 177EA(17) to the transaction described in Paragraphs 2 to 10 in the Draft Determination. While a proper construction of the circumstances may not alter the conclusion reached by the ATO, in our view the analysis requires more rigour and a better understanding of the commercial drivers for the special markets created by the Australian Securities Exchange and the transactions undertaken on such markets.

In particular:

- AFMA does not agree with the comment in Paragraph 24(a) to the extent that a participant in a dividend washing transaction is not the "true economic owner" of both the original parcel and the cum-dividend shares. Taking the example used in the Draft Determination, the participant is at all times exposed to share price movements on the shares held and, particularly, holds the shares sufficiently at risk so as to be a qualified person for the purpose of the 45-day rule. The issue, presumably, is whether the franking credits claimed are disproportionate to the shares held, but this does not, in AFMA's view, lead to a conclusion that the holder is not a true economic owner of the shares;
- The comments in Paragraph 24(b) of the Draft Determination are only tenable to the extent that the transaction is at a loss from a cash perspective. As noted above, AFMA believes it would be appropriate to include an additional example where the transaction is cash-positive and then seek to separately apply this circumstance;
- The comment in Paragraph 24(c) needs to be refined. The Draft Determination is based on a single transaction and not multiple transactions so consequently the comment appears out of context. In addition, to the extent that the holder of the shares holds them sufficiently at risk (as would be necessary for the purposes of the 45-day rule) then the exposure will be over a long period and would be consistent with long-term investment goals;
- There is an inference in Paragraph 24(d) that the only reason for transactions to occur on the Special Market is to source an imputation benefit. This significantly understates the commercial rationale for transactions that occur on the special market, or indeed the rationale for the creation of such markets in the first place. The special market is required to support the options market, allowing for settlement of call options that have been exercised on a cum-dividend basis

where the writer of the option does not hold the underlying security and needs to acquire the security so as to effect delivery. In the absence of a regulatory prohibition against naked short-selling, it is fundamental that this market be able to be created in respect of dividend paying securities. This point needs to be understood and more properly articulated in Paragraph 24(d) – particularly given the comment at Footnote 2 of the Draft Determination that "the origins of the Special Market were to allow orderly settlement of options positions"; and

- AFMA does not agree with the comments included in Paragraph 24(e) that suggest that the form of the transaction is different to its economic substance. Even in the most simple of dividend washing transactions, the form and substance are identical, being the sale of securities and, subsequently, the re-acquisition of a similar parcel of securities on a cum-dividend basis. The issue arising is that both parcels of securities have the entitlement to receive a dividend, together with any franking credits, such that the franking credits claimed are disproportionate to the shares held, but this does not permit the ATO to conclude that the substance of the transaction differs from its form.

Date of Effect

The Draft Determination states, at Paragraph 12, that "when the final Determination is issued, it is proposed to apply both before and after its date of issue."

AFMA submits that the Draft Determination needs to address issues arising from the potential application of Practice Statement PS LA 2011/27, that is, interpretations of the law that should only apply prospectively. For the reasons set out below, AFMA is of the view that ATO may have contributed to an industry perception that Section 177EA would not apply to dividend washing transactions. Accordingly, given the potential for such a perception, it may be appropriate to apply the terms of PS LA 2011/27 such that the view expressed in the Draft Determination applies prospectively.

In particular, the issuance and publication of Private Binding Rulings (**PBRs**) that concluded that Section 177EA would not apply to dividend washing transactions, described more fully below, may constitute an "ATO publication… (that) could reasonably have conveyed a different view of the law on a particular issue, to taxpayers generally, or to a particular class or industry group." Importantly, the conduct by the ATO with respect to guidance to the public on its stance to dividend washing transactions, and particularly the application of Section 177EA, may have, to use the words of the first factor in Paragraph 36 of the Practice Statement, "facilitated or contributed to taxpayers adopting a different view of the law." In this regard, it is noted that the carve-out for anti-avoidance provisions in Paragraph 36(c) does not apply where "there was an administrative practice that an anti-avoidance provision did not apply in a particular factual context." AFMA acknowledges that the ATO is reviewing the Practice Statement in light of the decision by the Federal Court in *Macquarie Bank Limited v Commissioner of Taxation*; notwithstanding AFMA is of the view that the timing issue needs to be addressed in the Draft Determination.

For completeness, it is noted that to the extent that the Draft Determination was to apply only a prospective basis, regardless as to whether this is from the date of issuance of the Draft Determination or the Final Determination, it will have no substantive application given the Media Release of the Assistant Treasurer of 28 June 2013 to amend the law to

insert a specific integrity provision, effective 1 July 2013, and the subsequent confirmation of this measure by the Government on 6 November 2013.

Administration issues

Private Binding Rulings

As the ATO is aware, the dividend washing transactions have been the subject of PBRs that have in turn been published (on a commercially sanitised basis) on the Private Binding Ruling Register – refer Authorisations 1012404641469 and 1012404629592. These PBRs were in respect of the year ended 30 June 2013 and were published on the PBR Register early in the 2013 calendar year.

The PBRs describe a set of facts that are relevantly consistent with other transactions that may be considered as "dividend washing." These facts see a Fund engaging in an investment strategy whereby the Fund sells a parcel of shares on an ex-dividend basis and then acquires cum-dividend shares in the same entity. Although not articulated in the PBR, it is clear the acquisition of the cum-dividend shares occurred after the sale of the original shares and occurred on the "special market" that allows for cum-dividend acquisitions after the ex-date. The PBRs do not specify details such as the sale price of the original shares, the acquisition price of the cum-dividend shares, the amount of the dividends or the amount of the franking credits attached to the dividends and, as such, could be considered to apply generically.

The PBRs specifically address whether the Commissioner will make a determination under Paragraph 177EA(5)(b) of the 1936 Act to deny the benefit of the franking credits on either the original shares or the cum-dividend shares. In respect of the application of Section 177EA, the PBRs state:

> "The relevant circumstances of the scheme indicate that there is no requisite purpose of conferring an imputation benefit under the financial arrangement. The Fund who receives the dividends and possible imputation credits is the true economic owner of the shares at all relevant times. There is no diversion of franking credit benefits from the true economic owners of the trust which might be said to undermine the principles of the imputation system."

On that basis, the ATO concluded that:

> "Having regard to the relevant circumstances of the scheme, the Commissioner has come to the view that the requisite purpose is not present and accordingly the Commissioner will not make a determination under Paragraph 177EA(5)(b) of the ITAA 1936 to deny the whole, or any part, of the imputation benefit received in relation to the dividends."

In AFMA's view, the facts set out in the PBRs would be substantively applicable to most, if not all, dividend washing transactions, including those set out in the Draft Determination.

Accordingly, while the PBRs were only technically binding on the applicants, the description of the facts and circumstances, and particularly the lack of distinguishing facts and circumstances between the transactions described in the PBRs and other dividend

washing transactions, resulted, in AFMA's view in an industry perception that such transactions would not result in the Commissioner making a determination under Section 177EA to deny the franking credits on either tranche of shares.

It is not abundantly clear from reading the Draft Determination what (if anything) has changed in the intervening period and what the basis is of the apparent change of ATO view. AFMA submits that the ATO needs to address the issuance of the PBRs in the manner that they were, to the extent that the ATO has now expressed a contrary view.

In particular, it is very difficult to reconcile the comments in the PBRs that the applicant "who receives the dividends and possible imputation credits is the true economic owner of the shares at all relevant times" to the comments in Paragraph 24(a) of the Draft Determination, which states that dividend washing transactions "offend one of the basic tenets of the imputation system…that the benefits of imputation should only be made available to the true economic owner of shares.

Treasury Discussion Paper

The other concerning aspect arising from the ATO's approach to the application of Part IVA to dividend washing transactions was the issuance of the Treasury Discussion Paper entitled "Preventing Dividend Washing" (**the Discussion Paper**) as released on 3 June 2013. This paper arose as a consequence of the announcement by the Government in the 2013-14 Federal Budget as to a specific legislative amendment to prevent dividend washing transactions occurring post 30 June 2013. As noted above, the outcome of the consultation process on the Discussion Paper, which AFMA was heavily involved in, was the announcement of a specific integrity rule deeming an investor engaged in a dividend washing transaction not to be a "qualified person" with respect to the franking credits attaching to the second tranche of shares, effective 1 July 2013.

The Discussion Paper itself did little to deter the industry perception by failing to provide any commentary that suggested that Section 177EA should apply to such transactions. To the extent that the ATO had provided advice to the Government prior to the Budget announcement that Section 177EA should apply to dividend washing transactions, it would be, in AFMA's view, reasonable for such advice to be reflected in the Treasury Discussion Paper.

Accordingly, as at 30 June 2013, participants were aware of the existence of two publicly available PBRs that suggested that Section 177EA would not apply to dividend washing transactions and a Treasury Discussion Paper that canvassed various legislative options to amend the law as at 1 July 2013 to ensure that there were no franking credits available on the second tranche of shares and did nothing to dispel the perception that arose from the PBRs.

Given the above and the significant period of time between the issuance of the PBRs and the Draft Determination, AFMA submits that it is incumbent upon the ATO to describe the basis for the issuance and subsequent publication of the PBRs, the advice given to Government regarding the application of Section 177EA to dividend washing transactions prior to the 2013 Budget announcement and what, if anything, has changed the ATO's view as expressed in the Draft Determination.

At a minimum, AFMA submits that the issuance/publication of the PBRs provided taxpayers with an expectation that the non-application of Section 177EA to dividend washing transactions was "reasonably arguable." This is important for the purpose of the "tax promoter rules" in Division 290 of Schedule 1 to the *Taxation Administration Act* 1953, and in AFMA's view this point should be made in the Draft Determination.

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In accordance with existing ATO protocols, AFMA understands that the comments in this Submission may be included in a Compendium to the Final Determination but otherwise the Submission will not be made publicly available. Please contact me on (02) 9776 7996 if this is not the case or if you would like to discuss any aspects of the foregoing.

Yours sincerely,

Rob Colquhoun
Director, Policy (Taxation)