15 April 2014

General Manager
Law Design Practice
The Treasury
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Via Email taxlawdesign@treasury.gov.au

Dear Treasury,

Preventing Dividend Washing
Exposure Draft

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.

AFMA welcomes the opportunity to provide comments in relation to the Exposure Draft and accompanying draft Explanatory Memorandum of the *Tax and Superannuation Laws Amendment (2014 Measures No. 2) Bill 2014: Preventing Distribution Washing,* as released by Treasury for comment on 24 March 2014.

General policy approach

As Treasury is aware, AFMA was involved in the consultation process in June 2013 regarding the appropriate legislative mechanism to address distribution washing. We note that the proposed legislation largely reflects AFMA's preferred policy position from June 2013, insofar as it represents a provision that is self-executing and seeks to minimise compliance costs for participants by not requiring changes to existing systems and processes. To that end, AFMA remains supportive of the legislative amendments.

That being said, in order for the legislative mechanism to deliver on its stated objectives, it is necessary that it operates with precision and requisite certainty. To that end, we

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are of the view that some of the comments in the draft Explanatory Memorandum, in particular, could be made clearer and be consistent with other provisions relevant to the dividend imputation system. We set out specific comments below.

Clarification of where interests are "substantially identical"

As noted in paragraphs 1.30 to 1.37 of the draft Explanatory Memorandum, a trigger for the distribution washing provisions to apply is that the washed interest must have been acquired after the disposal of a "substantially identical membership interest." Clearly the intention underpinning the legislation, for understandable reasons, is to extend the ambit of the distribution washing provisions to ensure that they apply to economically equivalent securities and not just identical securities.

Our concern is ensuring that the draft Explanatory Memorandum provides are clear articulation as to what is "substantially identical" in this context. It appears to be Treasury's view that different securities (that are equity for tax purposes) issued by the same entity, or by associate entities (as defined in Section 318 of the 1936 Act) will be "substantially identical" unless there are significant differences in the economics of the securities such that they are not economically fungible. Conversely, it appears that securities issued by non-associates should not be considered to be "substantially identical" even in circumstances where the economic rights are similar. For example, ordinary shares in entities that operate in the same industry may display a high degree of correlation in terms of traded price and may adopt similar dividend and franking policies, but should not be "substantially identical."

To the extent that these perspectives represent Treasury's view, a clear articulation of these points in the Explanatory Memorandum would be of benefit.

Definition of "connected entity" – alignment to Section 160APHI

AFMA notes that the proposed definition of "connected entity" in the Exposure Draft is extended to all associates, as defined in Section 318 of the 1936 Act.

This language is used elsewhere in the dividend imputation provisions, most notably in former Section 160APHI of the 1936 Act, which included an integrity provision imposing the "last in, first out" rule for disposal of substantially identical securities by connected entities. AFMA notes that in order for former Section 160APHI to apply, it is necessary that there is "an arrangement" between connected entities. Such a requirement is lacking in the proposed distribution washing provisions.

AFMA can foresee that by not including a requirement in the distribution washing provisions that there be an arrangement between connected parties, the costs of compliance for industry will increase considerably. This is because many entities that are associates for the purposes of Section 318 actually have little to no economic connection and certainly no visibility as to the transactions of the other. For example, the beneficiary of a widely held trust will be an associate of the trustee of the trust, but neither would expect to have oversight as to the other's transactions. As currently drafted, such visibility would be required to ensure that there are no transactions undertaken that inadvertently fall foul of the distribution washing provisions.

Accordingly, AFMA submits that the grouping mechanism in the proposed legislation be aligned to that set out in the former Section 160APHI.

Application of provisions where change in economic holding

AFMA has noted the approach adopted by Treasury in terms of the application of the distribution washing provisions where there is a significant change in the economic position of the investor, that is, that the provisions still apply. Taking the example from the draft Explanatory Memorandum, where an investor sells 100 shares on an ex-dividend basis in the ordinary market and then re-acquires 200 shares on a cum-dividend basis in the special market, the view of Treasury, and the construction of the proposed legislation, is that the provisions will apply to deny the investor the franking credits on 100 of the cum-dividend shares.

The policy intention behind the distribution washing measures was articulated by the then Assistant Treasurer in the Media Release of 28 June 2013, namely that the approach was to ensure that "investors are no longer able to receive two sets of franking credits on what is essentially the same parcel of shares." The implication behind this statement, which is consistent with the approach currently being adopted by the ATO to enforcement of potential distribution washing transactions under Part IVA, is that there is no change in the economic position for the investor. This position is reflected in paragraph 1.40 of the draft Explanatory Memorandum, which states that the "integrity rule is intended to address any case in which taxpayers may obtain multiple franking credits in respect of a single economic interest."

Accordingly, AFMA queries whether applying the distribution washing provisions in circumstances where there has been a material change in the economic exposure to the investor is consistent with the stated policy intent of the measures. We acknowledge that the provisions require sufficient integrity and certainty such that they do not apply solely to precisely exact parcels; however the current drafting applies more pervasively than AFMA's understanding as to the policy intention.

We note that consideration of investors' economic position is consistent with the structure of the holding period rules, especially the 30 delta requirement to determine whether positions are held sufficiently at risk.

Trading shares off market on a cum-dividend basis after the ex-date

We request that paragraph 1.17 be clarified or enhanced to the extent that it is possible for off-market transactions to occur after the ex-date on a cum-dividend basis. As described to AFMA, the reason for the "special market" is that it is the only mechanism through which writers of call options that are exercised on a cum-dividend basis can acquire stock to settle the exercise (to the extent to which such writers do not hold existing inventory to cover the exercise). If the comment in paragraph 1.17 is correct, then it would appear to call into question the reason for the existence of the special market.

AFMA requests that the comment in paragraph 1.17 be expanded to articulate the circumstances under which shares can be traded off-market on a cum-dividend basis

after the ex-date and hence circumstances in which the distribution washing provisions could apply.

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Please contact me on (02) 9776 7996 if you have any queries or comments.

Yours sincerely,

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