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Taxation Determination

Income tax: can section 177EA of the *Income Tax Assessment Act 1936* apply to a 'dividend washing' scheme of the type described in this Taxation Determination?

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Ruling

1. Yes. The application of Part IVA of the *Income Tax Assessment Act 1936*¹ to any particular scheme depends on a careful weighing of all the relevant facts and surrounding circumstances of each case. Without all relevant information, it is not possible to state definitively whether a provision in Part IVA applies to a particular scheme. However, the Commissioner's view is that section 177EA will generally apply to a 'dividend washing' scheme of the type described below at paragraphs 2 to 10 of this Taxation Determination.

Example

2. *The trustee for the Payton self managed superannuation fund (Payton) holds an interest, being a parcel of 10,000 shares, in ZCF Limited (ZCF) that is listed on the Australian Securities Exchange (ASX) (Parcel A). Payton has held Parcel A for at least 45 days.*
3. *On 12 August 2013 ZCF announces a fully franked dividend of 14c per share with a franking credit of 6c per share. Shares in ZCF will go ex-dividend (in that they will trade without an entitlement to receive this dividend) on 27 August 2013.*

¹ All legislative references are to the ITAA 1936 unless otherwise indicated.

4. *On 27 August 2013 Payton sells Parcel A (10,000 shares) for \$5.00 each on an ex-dividend basis on the normal ASX market; Payton's proceeds from the sale are \$50,000.*
5. *Payton uses the proceeds received from the sale of Parcel A to purchase a further 10,000 ZCF shares (Parcel B) on a 'Special Market'² operated by the ASX for \$5.16 per share; the total cost of this transaction is \$51,600.³ The Parcel B shares purchased on the Special Market include the rights to receive the franked dividends announced by ZCF on 12 August 2013. This is known as shares trading on a 'cum-dividend' basis.*
6. *The Special Market is open for trading from 27 August 2013 to 28 August 2013. ZCF Shares purchased on the Special Market can trade at a premium because shares purchased on this market include the rights to receive the franked dividends announced by ZCF on 12 August 2013.*
7. *On 14 October 2013 Payton receives franked dividends of \$1,400 with franking credits of \$600 in respect to both Parcel A and Parcel B; as such Payton receives dividends totalling \$2,800 including franking credits of \$1,200.*
8. *The result of the above transactions undertaken by Payton, excluding brokerage fees, is:*
 - (a) *a cost of \$1,600 which is the difference between the proceeds from the sale of Parcel A and the purchase of Parcel B (\$50,000 – \$51,600), and*
 - (b) *additional dividends of \$1,400 from Parcel B.*
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.*
10. *After undertaking the trades referred to in paragraphs 4 and 5 Payton still holds the same number of shares in ZCF. Parcel B will be held by Payton for at least 45 days after the date of purchase.*
11. *The application of Part IVA depends on the facts of the particular case. However, a 'dividend washing' scheme that includes the key elements as described in paragraphs 2 to 10 of this draft Determination, would likely be a scheme entered into for a more than incidental purpose of enabling a participant to obtain an imputation benefit for the purposes of paragraph 177EA(3)(e) in respect of the acquisition of the same, or substantially similar, quantity of Parcel B shares.*

² Upon request from a Trading Participant, the ASX will create a Special Market under the ASX Operating Rule Procedures [Procedure 2111] whereby Trading Participants may deal on a Trading Platform on a basis different to the existing quotation if a market for such dealing is established in accordance with the ASX Operating Rules. The Special Market operates independently from the ordinary market, such that shares that are trading on an ex dividend basis on the normal ASX market may be traded on a cum dividend basis on the Special Market. We understand that the origins of the Special Market were to allow orderly settlement of option positions. However, there is no requirement that trades conducted on the Special Markets are used only to settle option positions, such that any shares can be traded on the Special Markets if the Special Market is created for that share.

³ This Taxation Determination will also apply to such trades that are entered into 'off market' that is by mutual agreement with another Trading Participant that is executed outside the electronic marketplace by using the Trade Report window and applying the desired basis of quotation.

12. In situations where a more than incidental purpose of obtaining an imputation benefit is present, the Commissioner is entitled to make a determination pursuant to paragraph 177EA(5)(b) to deny an imputation benefit to Payton in respect of the franked distribution received on the parcel B shares. The effect of such a determination⁴ would be to unwind the usual 'gross up' and 'tax offset' treatment of the receipt of a franked distribution. Payton would thus include the \$1,400 cash amount of the dividend received on the parcel B shares in its assessable income, but would not include the attached \$600 franking credit in its assessable income and would not be entitled to a tax offset in respect of the \$600 franking credit.⁵

Date of effect

13. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

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⁴ Where the Commissioner has made a determination under paragraph 177EA(5)(b), the receiving entity of the franked distribution will not include the franking credit on the franked distribution in its assessable income and is not entitled to a tax offset in relation to that distribution (section 207-145 of the *Income Tax Assessment Act 1997*).

⁵ This Taxation Determination does not address the application of section 8-1 of the ITAA 1997 or section 177D to losses and outgoings incurred by a taxpayer in connection with a dividend washing scheme.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Explanation

14. Section 177EA is a general anti-avoidance rule that safeguards the operation of the imputation system. The purpose of section 177EA is to protect the imputation system from abuse and ensure that the benefits of the imputation system flow to the economic owner of the share which is the source of the franked distribution. Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 (Explanatory Memorandum) that introduced section 177EA states:

8.5 Two of the underlying principles of the imputation system are, firstly, that the benefits of imputation should only be available to the true economic owners of shares, and only to the extent that those taxpayers are able to use the franking credits themselves and, secondly, that tax paid at the company level is in broad terms imputed to shareholders proportionately to their shareholdings.

15. Subsection 177EA(3) is the basic application provision of section 177EA. The first condition for the application of section 177EA is that there is a scheme for a disposition of membership interests, or of an interest in membership interests, in a corporate tax entity: paragraph 177EA(3)(a).

16. A membership interest includes each interest, or a set of interests, in the entity or each right, or set of rights, in relation to the entity (section 960-135 of the *Income Tax Assessment Act 1997* (ITAA 1997)) and a 'corporate tax entity' includes a company: section 960-115 of the ITAA 1997.

17. The definition of scheme in subsection 177A(1) includes any agreement, arrangement, understanding, promise or undertaking (whether express or implied and whether legally enforceable or not), and any plan, proposal, course of action or course of conduct.

18. The term 'scheme for a disposition' is defined in subsection 177EA(14). The term is given an inclusive meaning, but is not limited, by reference to a scheme that involves any of the matters set out in paragraphs 177EA(14)(a) to 177EA(14)(f). In particular, paragraph 177EA(14)(b) includes a scheme that involves entering into any contract, arrangement, transaction or dealing that changes or otherwise affects the legal or equitable ownership of the membership interests or interest in membership interests.

19. The term 'disposition' is not statutorily defined; it is ordinarily defined to include the act or an instance of disposing of something.⁶ The Explanatory Memorandum at paragraph 8.63 states that for section 177EA to apply there does not need to be a legal disposition of a membership interest because it includes '*de facto* sales or dispositions as well as other transactions'.

⁶ The *Australian Oxford Dictionary* provides that "[d]isposition is the noun corresponding to *dispose* 'arrange, incline'.

20. A scheme that involves the buying of Parcel B shares on the same day that Parcel A shares are disposed of, is a 'scheme for a disposition' of membership interests as the legal ownership of the shares in question has changed (paragraphs 177EA(3)(a) and 177EA(14)(b)). But for the application of section 177EA, it could reasonably be expected that an entity (the *relevant taxpayer*) will receive an imputation benefit⁷ as a result of receiving a franked distribution in respect to both parcels of shares (paragraphs 177EA(3)(b), 177EA(3)(c) and 177EA(3)(d)).

21. The question that remains to be considered is whether any person who entered into or carried out the whole or part of a scheme in question did so for a purpose that was other than an incidental purpose of enabling the holder to obtain imputation benefits (paragraph 177EA(3)(e)). This purpose does not have to be a sole or dominant purpose of any party.

22. The relevant conclusion of purpose in relation to the scheme in question is an objective conclusion that is to be drawn from the relevant circumstances of the scheme. These circumstances include, but are not limited to, the circumstances set out in subsection 177EA(17), including the factors listed in subsection 177D(2).⁸ The relevant circumstances may individually or collectively indicate the requisite purpose. The finding of purpose that is required before section 177EA can apply may be drawn even if some of the listed circumstances do not apply to a particular scheme.

23. *Mills v. Commissioner of Taxation* [2012] HCA 51; 2012 ATC 20-360; (2012) 83 ATR 514 (*Mills*) concerned the application of section 177EA to an investor who had invested in Perpetual Exchangeable Resaleable Listed Securities V issued by the Commonwealth Bank of Australia. In regard to the assessment of the relevant circumstances the High Court noted that:

61. Two uncontroversial features of 'the relevant circumstances' to which s 177EA(3)(e) refers can usefully be noted. The first is that the relevance of the relevant circumstances lies in the extent to which they are probative of the ultimate question as to purpose. The second is that the circumstances referred to in s 177EA(17) are not exhaustive of the circumstances that might be probative of that ultimate question. They are nevertheless mandatory relevant considerations. Where they exist, they must be taken into account and their degree of relevance will vary according to the extent to which they are probative of the ultimate question.

24. In forming the relevant conclusion, the question is whether a reasonable person would infer from the circumstances pertaining to the dividend washing scheme, having regard to the relevant matters under subsection 177EA(17) and the factors in subsection 177D(2),⁹ that obtaining an imputation benefit on Parcel B is a more than an incidental purpose of one of the persons who entered into or carried out the scheme.

⁷ Imputation benefit is defined in subsection 995-1(1) of the ITAA 1997 to have the meaning given in subsection 204-30(6) which includes, amongst other things, an entitlement to a tax offset under Division 207 of the ITAA 1997 as a result of a distribution to a member of an entity. The tax offset is equal to the franking credit on the distribution (refer to list of tax offsets in section 13-1 and then subsection 207-20(2)).

⁸ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraphs 177D(b)(i) to (viii) of the ITAA 1936.

⁹ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraphs 177D(b)(i) to (viii) of the ITAA 1936.

25. The relevant circumstances of the dividend washing scheme are as follows:
- (a) The scheme, in substance, exposes the holder of Parcel A and Parcel B to the risk of holding a single parcel of shares, whilst obtaining imputation benefits on both Parcels (paragraph 177EA(17)(a)). This offends one of the basic tenets of the imputation system as explained in the Explanatory Memorandum (see paragraph 14 of this Taxation Determination) that accompanied the Bill which introduced of section 177EA. It states that the benefits of imputation should only be available to the true economic owners of shares.
 - (b) From a purely investment point of view, the only advantage of paying a premium to purchase the cum-dividend shares on the Special Market is the right to receive the additional dividend. That is, paying a premium will result in a loss on the transaction. It is only when the imputation benefit attached to the additional dividend is taken into account that the transaction makes commercial sense (paragraph 177EA(17)(f)).
 - (c) Where the dividend washing scheme is entered into on a regular basis, such 'churning' of a similar number of shares effectively exposes the holder to what is in substance a single parcel of shares and suggests a motivation other than long term investment goals (paragraph 177EA(17)(i)).
 - (d) The manner in which trades take place on the Special Market, that is the sourcing of the imputation benefit, indicates that tax considerations are a significant driver for the trade and it is not akin to an ordinary trade (paragraph 177D(2)(a)).¹⁰
 - (e) The substance of the arrangement is that the investment continues to be more or less exactly the same as the initial investment; that is the investment is simply one of holding a single parcel of shares with the corresponding level of exposure being to that single parcel of shares. However the legal form of the arrangement is that both parcels (Parcel A and Parcel B) will confer an entitlement to dividends and franking credits. This disparity between the form and substance of the scheme is indicative of the requisite purpose (paragraph 177D(2)(b)).¹¹

¹⁰ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraph 177D(b)(i).

¹¹ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraph 177D(b)(ii).

- (f) The timing of the scheme is very precise. The scheme can only be achieved on the days when the ASX operates the Special Market. If the holder tried to replicate the scheme by purchasing a second Parcel of cum-dividend shares on the ordinary market a significant amount of additional capital would be required.¹² Further, if a taxpayer owned both parcels of shares at the same time and then disposed of Parcel A, the application of the 'last-in first-out' rule in former section 160APHI would mean that the taxpayer would not satisfy the qualified person rules in respect of Parcel A, as they would be taken for the purpose of those rules to have actually disposed of Parcel B¹³ (paragraph 177D(2)(c)).¹⁴
- (g) It is likely that a participant of a dividend washing scheme will be entitled to claim the imputation benefits on both Parcels and their financial position will be improved by claiming the imputation benefits and reducing their tax liability or by receiving a refundable tax offset equal to or less than the imputation benefit (paragraphs 177D(2)(d) and 177D(2)(e)).¹⁵

26. As noted in paragraph 23 of the Taxation Determination the circumstances listed in subsection 177EA(17) are not exhaustive of the matters that may be probative of the ultimate question as to purpose. A counterfactual analysis, whilst not mandated by paragraph 177EA(3)(e), will assist in inferring a person's or entity's relevant purpose to obtain an imputation benefit and, if so, whether that purpose is incidental or not to some other purpose.¹⁶ It is considered in the present circumstances that the only counterfactual would be for an investor to maintain ownership of the ex-dividend shares. Indeed this counterfactual actually represents the substance of the investment strategy ignoring any entitlement to franking credits received in respect of Parcel B. The comparison of the counterfactual to the actual 'dividend washing' scheme would suggest a purpose of obtaining an imputation benefit.

27. The application of section 177EA to a particular scheme depends upon a careful weighing of all the relevant facts and surrounding circumstances. In the absence of all relevant information, it is not possible to state definitively whether section 177EA will apply to a particular scheme.

28. However, the consideration of the relevant circumstances (at paragraph 25 of this Taxation Determination), without more information, points to a likely conclusion that a person or entity undertaking the trades as described in the Example did so for a more than incidental purpose of enabling the holder of Parcel B to obtain an imputation benefit. The relevant person or entity that participated in the scheme, or part of the scheme, for that purpose is likely to be the holder. This 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, as long as the purpose of obtaining an imputation benefit was not a merely incidental purpose.

¹² On the basis that proceeds from the sale of Parcel A are no longer available to be used to purchase Parcel B - unless Parcel A is sold prior to the ex-dividend date. In that case dividends and franking credits would only be available on Parcel B.

¹³ This is on the basis that the shares in question (Parcel A) had not been held at risk for a minimum of 45 days (excluding the day of acquisition and disposal).

¹⁴ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraph 177D(b)(iii).

¹⁵ For schemes entered into, or commenced to be carried out, on or before 15 November 2012 refer to former subparagraphs 177D(b)(iv) and (v).

¹⁶ *Mills v. Federal Commissioner of Taxation* [2012] HCA 51 at [66]; 2012 ATC 20-360; 83 ATR 514 at 535 to 536.

29. Where section 177EA applies to a dividend washing scheme, the Commissioner may make a determination under paragraph 177EA(5)(b) that no imputation benefit is to arise in respect of the distribution or a specified part of a distribution that is made, or flows indirectly, to the holder of the shares (the same or substantially similar quantity of Parcel B shares) purchased on the Special Market on a cum-dividend basis as part of the dividend washing scheme.

30. The effect of such a determination is to strip away the benefit of the franking credit from the franked distribution received on Parcel B. In simple terms, the franked distribution on Parcel B will effectively be treated by the recipient in the assessment process as if it was an unfranked distribution. Therefore affected taxpayers should not include the grossed up value of the dividend received on Parcel B in their tax return (the dividend received on Parcel B should be included as assessable income in the tax return) and not claim an offset for the franking credit on parcel B.

References

Previous draft:

TD 2014/D1

Related Rulings/Determinations:

TR 2006/10

Subject references:

- cum interest & cum dividend securities
- franked dividends
- imputation credits
- imputation system
- Part IVA
- refund of imputation credits
- taxation determinations

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 160APHI
- ITAA 1936 177A(1)
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(iii)
- ITAA 1936 177D(b)(iv)
- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)
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