Ms Michelle Calder
Manager
Corporate Governance and Reporting Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: Corporations.Amendments@treasury.gov.au 16 May 2014

Dear Ms Calder,

Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014: submission by Law Council of Australia on Exposure Draft

1. These submissions are made by the Companies Committee of the Business Law Section of the Law Council of Australia (the Committee).

Key points

2. The key points the Committee wishes to bring to the attention of Treasury are as follows:

   (a) the Committee supports the proposed removal of the 100 Member Rule from s 249D and submits that the Rule should also be removed from s 252B in respect of managed investment schemes;

   (b) the Committee supports the proposal to introduce a pure solvency test for dividends, and to eliminate the requirement to calculate assets and liabilities by reference to accounting standards that do not apply to all companies, but it submits that the proposed s 254TA would introduce unnecessary regulation and introduce further anomalies, contrary to the Government's objective, and should be abandoned;

   (c) the Committee does not support the proposed amendments to the Annual Directors' Report relating to dividends, because they are unnecessary and unclear;

   (d) the Committee supports the Bill's proposals for limited reforms of the disclosure requirements for Remuneration Reports relating to the remuneration governance framework and options, and the proposed amendment to confine s 300A to listed disclosing entities, while suggesting that further work is needed in relation to this area of regulation, to reduce unnecessary regulation and enhance effective disclosure;

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(e) the Committee supports the proposed amendments to provide further relief for companies limited by guarantee with respect to the appointment and replacement of an auditor; and

(f) the Committee supports the amendment to the ASIC Act which proposes to permit members of the Takeovers Panel to perform Panel functions whilst abroad.

3. The members of the working group of the Committee who prepared these submissions would welcome the opportunity to meet with Treasury officials, particularly to discuss dividend law reform. The objective would be to reach consensus on a difficult legal subject upon which various attempts at statutory law reform have not been completely successful. A proposed meeting has already been discussed by our respective representatives. To assist in further understanding the Committee's position on dividend reform, also attached are papers presented and discussed at the Committee's annual workshop in 2012.

Submissions

4. *Removal of the 100 members rule: proposed amendment to s 249*D

It is proposed that the statutory right of at least 100 members to require the directors of a company to convene a general meeting will be repealed by amendment to s 249D. The consequential statutory right of members holding 50% of the votes of the requisitionists, enabling them personally to convene a general meeting if the directors do not do so (s 249E), will be likewise modified. A consequential amendment is that the regulation-making power with respect to the number of members (s 249D(1A)) will be repealed.

The statutory rights of members with at least 5% of the votes that may be cast at a general meeting of a company, to require the directors to convene a general meeting (s 249D) or themselves to convene a general meeting (s 249F), will not be affected. Nor will the proposed amendment affect the statutory right of members with at least 5% of the votes that may be cast on a resolution, or at least 100 members who are entitled to vote at a general meeting, to give notice of a resolution for a general meeting that has been effectively convened (s 249N).

The Committee supports the proposed amendment, on the ground that shareholder rights are adequately protected by the remaining provisions summarised above. Specifically, in the case of a company limited by guarantee with many members, while it will be harder to accumulate the 5% that will be necessary to compel the calling of the meeting, the members will be adequately protected by the ability of 100 members to place an item on the agenda for an AGM or other properly convened meeting.

The Committee submits that the same reasoning should apply to meetings of members of registered managed investment schemes, and accordingly a corresponding amendment should be made to s 252B(1). Consequently s 252B(1A) should be repealed.

5. *Proposed sections 254T and 254TA, and para 9.1 of the Small Business Guide (Dividends)*

5.1 *General observations*

These proposed sections would replace the existing net assets test with a pure solvency test, with additional requirements where declaration or payment of a dividend would reduce the company's share capital. It will be made clear that a dividend paid in accordance with the new provisions is authorised by law and is therefore not subject to the reduction of capital requirements of Part 2J.1. The present requirement that assets and liabilities are to be calculated for dividend purposes in accordance with accounting standards will be removed, concurrently with removal of the net assets test.

In the Committee's view, the proposals to move from the existing net assets test to a pure solvency test, and to abandon reliance on accounting standards for entities not subject to them, are to be welcomed as a matter of reform of corporations law. However, the Committee submits that the proposed drafting set out in the Exposure Draft will create further problems and uncertainties, which should be addressed.

Overall, the Committee submits that some amendments should be made to the proposed s 254T, and the proposed s 254TA should be abandoned as it is unnecessary as well as problematic. The two principal policy considerations underlying the law of maintenance of share capital, relating to creditor and shareholder protections, would be adequately addressed by a pure solvency test (addressing creditor concerns) and a requirement (addressing fairness to shareholders) that the dividend be declared or determined consistently with the company's constitution (if any) and any relevant special resolution of shareholders.

The Committee further suggests that the Explanatory Memorandum for the Bill should explicitly state that:

(a) these amendments will remove any requirement that dividends be declared or paid from profits and will abolish the maintenance of capital principle as it applies to dividends;

(b) section 254W(1) prevents a public company from declaring or paying a dividend which treats shareholders in a class of shareholders differentially (unless the company's constitution or a special resolution of the company permits it to do so), but a differential distribution may be achieved by selective reduction of capital under Part 2J.1; and

(c) when resolving to declare or pay a dividend, companies will need to take into account the taxation consequences of their decision, which are not addressed by these amendments.

For completeness, the Committee notes that the proposed sections, and our suggested amendments, adequately cater for Dividend Reinvestment Plans.

Our detailed comments on proposed ss 254T and 254TA are set out below.

5.2 *The dividend law should be cast in positive, not negative terms*

The proposed ss 254T(1) and (2) are expressed in negative language, appropriate for adding additional requirements for the payment of dividends, rather for the establishment of a new regime that overrides the existing law. The Committee submits that a provision cast in the form of a positive authority to declare or pay dividends would be far preferable. In particular, this would allow s 254TA to be abandoned, which the Committee considers would be desirable for the reasons set out in 5.5 to 5.8 below. See the Committee's suggested re-drafting of s 254T(1) and (2), at 5.9 below.

5.3 *Section 254T(2) should relate to the determination to pay a dividend, rather than the payment*

The proposed s 254T(2) would enable dividends to be paid without being declared, and would require the directors' reasonable belief in solvency to apply immediately before the dividend is paid. In a large company there is inevitably a gap between the date of the decision to pay a dividend and the date of payment.

The legal requirement for a lawful dividend should operate primarily at the time of the decision rather than the time of payment. The proposed s 254T(2) should be re-drafted in positive terms, using the language of the replaceable rule in s 254U,, to provide that the solvency test is to be satisfied immediately before the company's determination to pay the dividend. See the Committee's suggested re-drafting of s 254T(1) and (2), at 5.9 below.

The Committee's proposed formulation will require the directors to consider, immediately before making their determination, whether the company will be solvent immediately after the dividend is paid. They will have to take into account prospective changes to the company's financial position between the time of their decision and the time when the dividends are paid. The directors will normally fix a time for payment and under s 254V(1) a debt for payment of dividends will arise at that time. It will be in the interests of not only the company, but also the directors, to have the shortest practicable gap between the determination and the time fixed for payment, because the directors' statutory and general law duties of good faith and care, as well as potential insolvent trading liability (see below), will require them to oversee the monitoring of the company's financial health during that period.

5.4 *The solvency test in the proposed s 254T should be aligned to s 588H(2)*

Under the proposed s 254T, a dividend will be validly declared or paid only if the directors reasonably believe that the company will be solvent. The proposed notes to s 254T(1) and (2) draw attention to a director's duty to prevent insolvent trading on payment of dividends, under s 588G.

The Committee submits that it would be helpful if the solvency test in s 254T were aligned with the corresponding test in s 588H(2). Otherwise directors will have potential liability under two differently expressed criteria: namely, under ss 256D(3) and (4) for involvement in a contravention by their company of the proposed new dividend provision, and also under s 588G (subject to the defences in s 588H).

Thus, the proposed s 254T(1) would authorise a company to declare a dividend if, but only if, immediately before the dividend is declared, the directors have reasonable grounds to expect, and do expect, that the company will be solvent immediately after the dividend is declared.

Corresponding amendments should be made to the proposed s 254T(2). Sections 588G and 588H will have the effect that, to avoid insolvent trading liability, the directors' expectation of solvency will have to exist at the time fixed the payment (if any) and (under s 588G(1A)) the time of payment, as well as (under the proposed s 254T) immediately before their determination to pay the dividend.

See the Committee's suggested re-drafting of s 254T(1) and (2), at 5.9 below.

5.5 *The proposed s 254TA is neither necessary nor appropriate and should be abandoned*

If the proposed s 254T is re-cast in positive terms along the lines proposed in para 5.2, the proposed s 254TA will no longer be necessary and should be abandoned.

The Committee believes the abandonment of the proposed s 254TA is desirable for several reasons:

(a) As proposed, the provision is not appropriate and simply will not work for many companies (including those with multiple classes of shares with different dividend rights) - see paras 5.6 and 5.7.

(b) To the extent that there is a need to ensure dividends are fair and reasonable to a company's shareholders as a whole, this can better be achieved by requiring dividends to be consistent with the company's constitution or any relevant special resolution of the company - see para 5.8.

(c) By imposing additional restrictions on dividends that involve reduction of share capital, proposed s 254TA would preserve the vagaries surrounding the legal concept of profit in the dividend context. The Committee believes it would be far preferable to have a stand-alone authority for dividends paid in accordance with the new solvency test (and consistency with the company's constitution and any relevant special resolution) that avoids the uncertainty and confusion to which the profits test gives rise.

5.6 *The "equal reduction" requirement does not work, if the company has more than one class of shares with differential dividend rights*

The proposed s 254TA(1) will permit a company to reduce its share capital by declaring or paying a dividend only if the dividend is declared or paid in accordance with proposed s 254T, *and* the reduction in share capital is an equal reduction. A reduction is an equal reduction if, inter alia, it relates only to ordinary shares.

"Ordinary shares" are not defined, but in the Part 2J.1 context commentators have suggested that shares are ordinary shares if the shareholder has the right to participate in dividends after any preferential dividend has been paid, the right to vote, the non-preferential right to a return of capital on winding up, the right to

participate in the ultimate surplus assets on winding up, and the right to participate in any corporate reconstruction - in each case proportionally to the number of shares held subject to any prior rights of other classes of shareholders[1].

Hence, where a proposed dividend reduces the company's share capital (for example, when there are no available profits for distribution), the only permitted dividend will be a dividend declared or paid in favour of ordinary shareholders. Holders of other classes of shares (such as preference shares) will be precluded from receiving such a dividend under this section. And yet the terms of issue or constitutional provisions relating to another class of shares may well give the shareholders in that class legal rights for preferential distribution. The overall effect may be that a company, seeking to avoid exposure to legal liability but wishing to pay a dividend otherwise than out of profits, will simply be precluded from doing so.

Moreover, where the company has some profits but not enough to support the dividends that the directors want to pay to preference shareholders and ordinary shareholders, there may be a question as to whether the drafting of the proposed ss 254T and 254TA would permit the use of the profits to pay the preference dividend and then payment of the ordinary shareholders' dividend out of capital.

The drafters may have intended to permit dividends to be paid other than to ordinary shareholders if the company follows the procedure for a selective reduction of capital (Explanatory Memorandum, para 7). But it is questionable whether such a drafting intention is achieved, and moreover, the imposition of a selective capital reduction regime for payment of dividends on, say, preference shares would be very onerous and unacceptable.

This is not a problem "on the margin". Of the top 20 listed companies, five (ANZ, CBA, NAB, Westpac and Suncorp) have preference shares on issue. At the other end of the economic spectrum, many proprietary companies have several classes of shares with differential rights.

5.7 The "equal reduction" requirement is inappropriate in the dividend context

As used in Part 2J.1 concerning authorised reductions of capital, the concept of an equal reduction is employed primarily to distinguish cases where shareholder approval by ordinary resolution will suffice, from cases where fairness requires approval by special resolution with voting restrictions. The equal reduction requirement is not a general "fairness to shareholders" requirement, that consideration being separately addressed in s 256B(1)(a).

Therefore by employing the equal reduction concept in the dividend context, the proposed s 254TA is adapting that concept to new and different circumstances. In the dividend context there is no issue about shareholder voting unless (unusually) the constitution empowers the shareholders rather than the directors to make the dividend decision. The Committee submits that this re-deployment of the equal reduction concept is inappropriate.

[1] See *Ford's Principles of Corporations Law* (looseleaf) [24.560]; *Austin & Black's Annotations to the Corporations Act* (looseleaf) [2J.256B].

The inappropriateness of using the equal reduction concept in the dividend context produces several unfortunate consequences. First, as noted at 5.6 above, the concept does not work where there is more than one class of shares and there are differential dividend rights.

Second, as to the definition of "equal reduction" in proposed s 254TA(2):

(a) there may be a question as to whether proposed s 254TA(2)(c), which requires that the terms of the reduction be the same for each holder "disregarding differences" that are set out, is intended to:

   (i) allow differential distributions where the difference is produced by one of the listed matters (e.g., to permit a distribution to be an equal reduction even though some but not all shareholders receive an amount which includes extra accrued dividend entitlements); or

   (ii) require that the distribution be the same to every shareholder, disregarding the listed matters (e.g., preventing a shareholder to receive an extra amount of dividend to reflect accrued entitlements); and

(b) the concept underlying proposed s 254TA(2)(c)(iii) ("disregarding differences that are introduced solely to ensure that each shareholder is left with a whole number of shares") is not clear - in a reduction of capital this provision is needed where shares are to be cancelled, but it is hard to envisage circumstances in which the concept would apply to a dividend out of capital, whether in cash or in specie.

5.8 The "equal reduction" requirement is unnecessary in the dividend context, and constitutional protection is to be preferred

The proposed s 254T, by introducing a pure solvency test, will do away with the additional requirements in the present s 254T regarding avoiding material prejudice to the company's ability to pay creditors, and ensuring that the payment of the dividend is fair and reasonable to the company's shareholders as a whole.

Removing the "material prejudice to creditors" test is justified because the dividend test will be a solvency test, and nothing more is needed. The purpose of employing the equal reduction concept in the dividend context seems to be to address the concern that a dividend that reduces share capital will not be fair and reasonable to shareholders as a whole unless it is paid to ordinary shareholders proportionately to their holdings.

However, that requirement is adequately addressed by other parts of corporations law. First, s 254W separately addresses the position of public companies, proprietary and no liability companies. In particular, s 254W(1) requires that each share in a class of shares in a public company must have the same dividend rights unless the company has a constitution that provides otherwise or differential rights are provided for by special resolution. Importantly, and in contrast with proposed s 254TA, s 254W(1) addresses the issue of fairness on a class-by-class basis, so as

to allow for the position of classes of shares with differential dividend rights (such as preference shares), and it addresses the shareholder fairness problem by requiring compliance with constitutional provisions or a special resolution (presumably on the basis that minority shareholders who are outvoted have access to the oppression remedy).

Second, the rights of shareholders in each class of issued shares can be addressed by the corporate constitution, if the company has a constitution, any relevant special resolution of the company, and the terms of issue of the shares. Shareholders whose rights are affected by constitutional provisions, a special resolution or the terms of issue of shares have the range of protections that company law allows, including adoption or amendment of constitutional provisions prevailing over any future special resolution or future terms of issue, and the general shareholder rights with respect to oppression, derivative actions and winding up.

It is open to a company to adopt constitutional provisions not only addressing distribution entitlements, but also imposing additional requirements, or restrictions, with respect to dividend distributions, where shareholders may wish to have additional protections. Additionally, the company may adopt a special resolution stating the rights attached to a class of shares (for example, see s 254A(2) with respect to preference shares).

In order to ensure that such constitutional provisions and special resolutions are effective, the Committee submits that the proposed s 254T should be amended to require that a dividend be declared or paid in a manner that is consistent with the company's constitution, if it has one, or any special resolution relating to dividend rights. See the Committee's suggested re-drafting of s 254T(1) and (2), at 5.9 below.

The effect of this change would be to allow the shareholders to prescribe additional requirements for lawful dividends, such as a requirement that the dividend be paid only to a particular class of shareholders, or at differential rates for different classes of shareholders, or even at differential rates within a single class of shareholders. Shareholders could, in a particular case, require the dividends to be paid only out of profits, or out of some identified account. The above drafting would apply to constitutional provisions and special resolutions in place at the time of commencement of the new provision, as well as new provisions subsequently adopted.

The Committee submits that no further shareholder protection would be required in the dividend context, as s 254W and the general shareholder protections are sufficient. Accordingly proposed s 254TA should be abandoned.

The abandonment of the proposed s 254TA would mean that some distributions that currently must be made by reduction of capital under Part 2J.1, with shareholder approval by ordinary resolution or special resolution (as the case may be) will come to be permissible by way of declaration or determination to pay a dividend if the constitution does not provide otherwise. Under the usual constitutional provisions, such a dividend decision will be made by the directors without shareholder approval. The Committee submits that, if the solvency test

and consistency with the corporate constitution is stipulated in the dividend law, this would be a positive consequence of dividend law reform.

Such a reform would give Australian companies enhanced capital flexibility. It would be an important step in the implementation of the present Government's policy to remove unnecessary regulation. It would at last achieve the policy goals enunciated, but not successfully implemented, in the Explanatory Memorandum for the 2010 amendments.

Part 2J.1 would remain available to be used in circumstances other than a solvent distribution in accordance with s 254W and constitutional requirements: for example, where the directors judge it to be advisable to put their proposed distribution to shareholders; , or where a differential distribution amongst members of a class of shares is proposed; or in cases where a capital reduction does not involve a distribution of cash or other assets, but, rather, the cancellation of liabilities; or where the proposal includes cancellation of shares (see s 254Y).

5.9 Proposed re-drafting of s 254T

In order to clarify our submissions in 5.2-5.8 above, the Committee offers the following reformulation of s 254T:

(1) A company may declare a dividend if (but only if):

(a) immediately before the dividend is declared, the directors have reasonable grounds to expect, and do expect, that the company will be solvent immediately after the dividend is declared; and

(b) *the declaration of the dividend is consistent with the company's constitution (if the company has a constitution), or any special resolution of the company relating to dividend rights.*

Note 1: For a director's duty to prevent insolvent trading on declaration of dividends, see sections 588G and 588H.

Note 2: A dividend declared in accordance with this subsection is authorised by law, including for the purposes of section 256B.

(2) A company may determine to pay a dividend if (but only if):

(a) immediately before the determination is made, the directors have reasonable grounds to expect, and do expect, that the company will be solvent immediately after the dividend is paid; and

(b) the payment of the dividend is consistent with the company's constitution (if the company has a constitution), or any special resolution of the company relating to dividend rights.

Note 1: For a director's duty to prevent insolvent trading on payment of dividends, see sections 588G and 588H.

Note 2: A dividend paid in accordance with this subsection is authorised by law, including for the purposes of section 256B.

(3) Subsection (2) does not apply to a dividend that is declared.

Re-wording the proposed s 254T in this way would abolish the legal distinction (though not the commercial distinction) between interim and final dividends. As a matter of law, a dividend would be permissible if and only if the solvency and constitutional tests were satisfied at the time of the dividend decision, regardless of whether for commercial purposes the directors' decision is intended to be an interim or final dividend decision for the relevant financial year. It would not be permissible, under this wording, for directors to resolve to pay an interim dividend on the ground that they anticipated that the company would become solvent by the end of the financial year, though it was not reasonably expected to be solvent at the time of payment. The Committee believes that is a good outcome.

6. *Proposed ss 300(1)(a) and (ba): disclosure of details of the source of dividends paid otherwise the out of profits*

Section 300 prescribes specific information to be included in the Annual Directors' Report of a company that is required to have such a report. Currently subparagraph (1)(a) requires the report for a financial year to include details of dividends or distributions paid to members during the year. An amendment is proposed to add the words: "including details of the source of any dividends paid otherwise than out of profits".

Additionally, it is proposed that a new subparagraph 300(1)(ba) be introduced, requiring that if dividends were paid to members during the year, and the dividends were paid otherwise than out of profits, that the board policy for determining the amount and source of dividends be disclosed.

The Explanatory Memorandum to the Exposure Draft, para 9, describes the additional reporting obligations as "an important integrity measure" that will "ensure that shareholders have the information they need about a company's dividend policy to make informed investment decisions". However, the Committee submits that the amendments are unnecessary and will not achieve any such objective, for the following reasons.

The words "details of the source of any dividends" in proposed s 300(1)(a) and "the amount and source of dividends" in proposed s 300(1)(ba) are unclear. Identifying the way in which a dividend is accounted for may not be informative, and the source of payment may be equally uninformative (e.g., the source might simply be cash).

Additionally, the Committee is concerned that these requirements preserve the distinction between dividends paid out of profits and other dividends, a difficult and ambiguous distinction which the 2010 amendments were intended to overcome (see 5.5 above).

Further, if the basic requirements for a valid dividend are solvency and constitutional authority, as the Committee submits should be the case, requiring additional information regarding the source of the dividend does not seem justified.

The Committee therefore submits that the additional requirements will be undesirable and of no utility, and therefore that the proposed ss 300(1)(a) and (ba) be abandoned.

It is likely to be helpful for shareholders to be told about the board's dividend policy, without specifying the source of dividends. But the Committee submits that such information is amply conveyed by the financial report without legislative amendment.

7. *Proposed changes to s 300A(1): disclosure requirements in remuneration reports of disclosing entities*

The Committee supports all of the proposed changes to s 300A, for the reasons given below, and encourages the Government to proceed with them. However, the Committee submits that, given the present Government's policy to remove unnecessary regulation and red tape, it would be appropriate to revisit the whole of the remuneration reporting requirements in the next round of corporate law revision. The current requirements of s 300A and the Corporations Regulations are highly prescriptive and in many respects, difficult to interpret, and ultimately unhelpful in assisting retail shareholders to understand remuneration policies adopted by reporting entities. The Committee encourages the Government to revisit the report by the Corporations and Markets Advisory Committee on *Executive Remuneration* (April 2011).

The proposed s 300A(1)(aa) will require the Annual Directors' Report of a disclosing entity for a financial year to include, in a separate and clearly defined section of the report or in the financial report, a description of the company's process (the **remuneration governance framework**) for determining remuneration of key management personnel. This proposal is in accordance with current good practice and is supported.

Section 300A(1)(e)(iv) currently requires disclosure of the value of options granted to a member of the key management personnel as part of their remuneration which have lapsed during the financial year because a vesting condition was not satisfied. It is proposed that this be replaced by a provision requiring disclosure of the number of options that have lapsed, and the year in which those options were granted. The information produced by the current requirement lacks utility, and the proposed disclosure will be more straightforward.

Section 300A(1)(e)(vi) requires disclosure of the percentage of the value of the remuneration of each member of the key management personnel that consists of options. It is proposed that this provision be repealed. The Committee agrees that this information is unnecessary, given the disclosure required in reg 2M.3.03.

Section 300A currently applies to any disclosing entity that is a company: s 300A(2). It is proposed that the application of the section be confined, by amendment to s 300A(2), to listed disclosing entities. The Committee agrees that the level of disclosure required by s 300A is less relevant for unlisted disclosing entities because they are not required to hold an annual general meeting and place the remuneration report before shareholders for a non-binding resolution.

8. *Determining a company's financial year: proposed note to s 323D(2A)*

The Committee supports the proposed note to s 323D(2A).

9. *Appointment of auditors of a company limited by guarantee: proposed ss 327A(1A), 327B(1A) and note to s 327C(1)*

The amendments proposed to ss 327A and 327B, and the proposed note to s 327C(1), are intended to relieve a small company limited by guarantee, and a company limited by guarantee with revenue falling within s 301(3) which elects to have its accounts reviewed rather than audited, from the obligation to appoint and replace an auditor. In the Committee's view, the proposals reflect the drafter's objective.

10. *Transitional provisions*

The Committee has no submission to make in respect of the transitional provisions in proposed Part 10.24, except with respect to proposed s 1550.

The proposed s 1550 states that proposed s 254TA will apply in relation to dividends declared or paid in accordance with s 254T as repealed and substituted by the amending Act. It is not clear whether that provision is intended to have a retrospective application, as regards dividends declared and dividends paid before the commencement of the amending Act. In principle, retrospective application should be expressly avoided by stating that proposed s 254TA will apply in relation to dividends declared or paid *after the commencement of the amending Act* in accordance with the repealed s 254T.

The Committee's preferred position is that proposed s 254TA be abandoned, for the reasons explained above.

11. *Amendments to the ASIC Act*

The Committee supports the proposed amendment to s 174 of the ASIC Act, which will authorise the Panel to exercise functions and powers outside Australia. This will avoid any technical objection to Panel members participating in the Panel's work (e.g., Panel teleconferences) whilst overseas, typically travelling to fulfil other professional obligations.

Otherwise the Committee has no submissions to make on the proposals to amend the ASIC Act, relating to the role of the Remuneration Tribunal.

12. *Consequential amendments to the Financial Sector (Business Transfer and Group Restructure) Act 1999*

The Committee has no submissions to make on this proposal, which is merely a note drawing attention to proposed s 254T.

Conclusion and further contact

13. The Committee would be pleased to discuss any aspect of this submission. As mentioned above, the working group of the Committee would appreciate the opportunity to meet with Treasury officials.

14. Please contact the chair of the Committee, Bruce Cowley on (07) 3119 6213 if you would like to do so.

Yours sincerely,

John Keeves
Chairman, Business Law Section

Law Council of Australia
Business Law Section

Difficulties with and proposals to reform Australia's dividend rules

A paper by Robert Austin and Greg Golding

Crowne Plaza
Adelaide
20 October 2012

General introduction

Prior to 28 June 2010, Australian statutory dividend law stated that a dividend could be paid only out of profits: former s 254T. The Corporations Amendment (Corporate Reporting Reform) Act 2010 (Cth) repealed that provision, and enacted a new s 254T, which prohibited payment of a dividend unless three tests (relating to balance sheet surplus, fairness to shareholders and absence of prejudice to creditors) were satisfied. But the poor drafting of the new s 254T has posed some serious problems. Now there is considerable uncertainty as to whether, and if so in what circumstances, a dividend can be paid otherwise than out of current year profits and profit reserves, and where there are current year profits, whether a dividend can be paid if there are accumulated losses.

These questions are important for company directors and executives, lawyers advising their client companies on whether proposed distributions can lawfully be made, and corporate financial strategists searching for the most efficient capital management programs. They are also important for taxation lawyers and the Australian Taxation Office, because distributions of profit and distributions reducing share capital produce importantly different taxation consequences. The ATO has addressed some of the tax issues in its important Taxation Ruling TR 2012/5 (June 2012).

As part of the process that led to the issuing of TR 2012/5, the ATO briefed Mr AH Slater QC and Mr JO Hmelnitsky of the New South Wales bar to provide a written opinion (the **Joint Opinion**) in response to a series of questions about the company law and taxation effects of the new s 254T. The Joint Opinion, dated 29 November 2011, was publicly released and is available on the ATO website. It is a very important and useful analysis of the scope and context of s 254T as well as the taxation consequences of the provision. In part, the present paper is a review of the Joint Opinion and its implications.

At about the same time as the Joint Opinion was prepared, Treasury released a Discussion Paper, *Proposed Amendments to the Corporations Act* (**Treasury Discussion Paper**), the principal part of which reviewed the new dividend law and invited submissions on four options for dealing with the dividends test: namely to retain the new s 254T as enacted in 2010; or to adopt a solvency test; or to reinstate the former profits test; or to adopt an arrangement under which a company would have a choice of two ways of determining whether it is able to pay a dividend. 27 submissions, including a submission by the Law Council of Australia, were received and most are available on the Treasury website. The submissions strongly favoured the adoption of a solvency test based on the New Zealand model. The Treasury's response is not yet known.

This paper is in two parts. Part A, by Robert Austin, reviews Australian dividend law after the enactment of the new s 254T, in light of the Joint Opinion. Part B, by Greg Golding (with assistance from Mark Vanderneut) addresses reform and policy issues.

PART A: DIVIDEND LAW AFTER THE 2010 REFORM

A1. The new s 254T and surrounding provisions

Before 28 June 2010, the declaration and payment of dividends by companies was governed by s 254T, which simply said that a dividend may only be paid out of profits of the company. In that form, the provision was introduced by the Company Law Review Act 1998, but there had been a similar provision in the Uniform Companies Act 1961, and predecessor provisions dating back to the Companies Act 1896 (Vic) s 48 and the Bank of New South Wales Act 1850 (NSW) s 16.

Since the 1998 amendments, the statutory proposition that dividends are to be paid only out of profits has been supported by some other provisions. Section 588G requires directors to prevent their company from incurring a debt if they are aware, or a reasonable person in their position would be aware, of grounds for suspecting insolvency. Under s 588FG, paying a dividend is deemed to be the incurring of a debt at the time the dividend is paid or declared. Section 254W demands that the shareholders of each class of shares in a public company are to have the same dividend rights, unless the corporate constitution provides otherwise or different dividend rights are provided for by special resolution. Section 254V provides that the company does not incur a debt merely by fixing the amount or time for payment of a dividend, and says the debt arises only when the time fixed for payment arrives, and the decision to pay a dividend may be revoked until that time.

Section 254U is a replaceable rule authorising the directors to determine that a dividend is payable and fix the amount, time for payment and method of payment. If a company has that replaceable rule and the directors act under it, they may revoke their decision until the time fixed for payment of the dividend arrives. The introduction of that replaceable rule confirmed a trend in constitutional provisions, to permit the directors - rather than the general meeting on the advice of the directors - to make the decision about a dividend.

The Corporations Amendment (Corporate Reporting Reform) Act 2010 (Cth) (**the 2010 Act**) repealed the statutory provision governing the declaration and payment of dividends (**former s 254T**), and introduced a new provision in radically different terms (**new s 254T**). Section 254T(1) says a company must not pay a dividend unless:

(a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of dividends; and
(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

According to s 254T(2), assets and liabilities are to be calculated, for the purposes of the balance sheet test, in accordance with accounting standards in force at the relevant time.

A2. Why was the new s 254T enacted?

The enactment of the new s 254T appears to have been the result of dissatisfaction with the dividend law (including the former s 254T) in the accounting profession. In 2002 the Legislation Review Board of the Australian Accounting Research Foundation published a discussion paper, *Payment of Dividends under the Corporation Act 2001*. The paper canvassed the background of the then current provisions relating to the payment of dividends, noting some difficulties presented by the provisions and comparing the approaches adopted in other jurisdictions. The paper criticised the dividend law as outdated, in light of recent changes to the law that generally gave greater emphasis to solvency requirements than to the concept of capital maintenance. The paper identified three options for determining the amount available for distribution as a dividend: that dividends may only be paid out of profits (the existing approach at the time); a solvency test; and a going concern test. The paper advocated a solvency test having regard to Canadian and New Zealand legislation on the subject, but it did not support the "balance sheet test" in the second limb of the legislation of those countries.

The recommendations in the paper were supported, approximately, in the explanatory memorandum to the Corporations Amendment (Corporate Reporting Reform) Bill 2010 (**Explanatory Memorandum**). The Explanatory Memorandum reported that industry had raised three concerns with the "profits test" (that is, the requirement that a dividend may only be paid out of company profits).

The first concern was said to be that the Corporations Act did not provide guidance about, or a definition of, the term "profits", and further, the legal precedents on the issue were outdated and complex and not in line with current accounting principles, so it was difficult for directors to understand the legal requirements. The "legal precedents" were not identified in the Explanatory Memorandum, but presumably the drafters had in mind the old dividend rules summarised, for example, in *Ford's Principles of Corporations Law* (looseleaf), [18.150]-[18.210].

It is true that in some respects the dividend rules do not accord with modern accounting practice as reflected in the Australian Accounting Standards, but that seems more an argument for updating the dividend rules than for abandoning them.

The second concern of industry, as recorded in the Explanatory Memorandum, was that the nature of accounting principles for calculating profits had changed over time, particularly by the adoption of International Financial Reporting Standards (**IFRS**), under which the recognition of fair value (whether realised or unrealised) impacts on the profitability of the company. This is said to make the profitability of Australian companies increasingly volatile, with a large number of non-cash expenses being included in the result. The consequence of applying the Accounting Standards could be, according to the Explanatory Memorandum, that a company would have sufficient cash to pay a dividend to shareholders but would be prevented by the former s 254T from doing so, because its accounting profits had been eliminated by non-cash expenses.

The problem is a serious one. It is a problem about the Accounting Standards and logically the solution would be to adjust the Accounting Standards to avoid the unsatisfactory consequences. The difficulty with doing so is that the distortion of traditional profit reporting outcomes is mandated by IFRS and so change would have to come at that international level.

The third concern, echoing the Australian Accounting Research Foundation paper, was said to be that the requirement that companies pay dividends only out of profits is inconsistent with the trend to lessen the significance of the capital maintenance doctrine in Australia. The Explanatory Memorandum referred to the abolition of the concept of par value for shares, legislation permitting companies to undertake share buy-backs without court approval, legislation removing the need the court approval of capital reductions - and presumably the drafters would now add the Bill that became the Corporations Amendment (Sons of Gwalia) Act 2010 (Cth).

This third concern is curious in two respects. First, the fact that in various specific ways the exceptions to the doctrine of maintenance of capital have been widened does not necessarily justify the abandonment of a cardinal application of the doctrine, namely the application of the doctrine to direct corporate distributions to shareholders. In one sense, the development of exceptions reinforces and confirms the rule to which the exceptions apply. As will be shown below, there are grounds for believing that the doctrine of maintenance of capital remains a strong and, indeed, fundamental tenet of company law, applied (for example) in the Joint Opinion. Second, taking a stand based on the legal developments seems to have excused the drafters from considering direct commercial and policy consequences of allowing dividends to be paid otherwise than out of profits. Is it desirable to allow directors (by use of the power to pay dividends) to manage the company's capital regardless of profit, without any need for

the kind of shareholder approval and ASIC review that would be involved in a reduction of share capital under Part 2J.1? Are the requirements relating to solvency, balance sheet surplus, fairness to shareholders and absence of material prejudice to creditors sufficient protections to ensure a fair outcome?

All in all, the justification for the reform that took effect in the new s 254T was less than compelling. There is a case for more flexible capital management under supervision of the board of directors, but it was not made out in the Explanatory Memorandum. Policy issues are further developed in Part B of this paper.

A3. Problems with the new s 254T

That the new s 254T was an unsatisfactory attempt to reform a complex corporate finance law is immediately suggested by the use of the word "declared" in s 254T(1)(a). That choice of language appears to have ignored the sections immediately following s 254T, which (as noted above) expressly allow companies to determine and pay dividends without ever declaring that a dividend be paid, and to revoke their decision at any time prior to the due date for payment of the dividend. The use of the word "declared" was troubling in light of these statutory provisions, and also in light of the fact that a significant number of listed and other companies, relying on the statutory provisions, had amended their constitutional provisions regarding dividends so as to remove the power to declare a dividend and instead, authorise the board of directors only to determine and resolve to pay dividends. The awkward resurfacing of the concept of declaring a dividend in the new s 254T was overcome by most lawyers taking the generous view that in the new provision, the word "declared" was used in a broad rather than a technical sense, so as to encompass both the declaration of a dividend and a determination to pay a dividend on a stated date.

There were, however, more serious problems with the new section. One was that the drafters evidently disregarded the corporate constitution. Many companies adopt constitutions rather than relying on the replaceable rules, and until 2010, constitutions sometimes provided that dividends could be paid (or declared and paid) only out of profits. As a matter of drafting, the new s 254T did not override the corporate constitution. By providing that "a company must not pay a dividend" unless the new criteria are satisfied, the section added to whatever requirements might be found in the constitution. The result was that after 28 June 2010, some companies (including some listed companies) were permitted to pay dividends only if they satisfied a double requirement: that the dividend be paid only out of profits, and that the balance sheet and other tests in the new section be satisfied.

That point about the negative drafting of the new s 254T leads on to a still more serious issue. Part 2J.1 Division 1 (ss 256B-256E) of the Corporations Act governs the circumstances in which a company is permitted to reduce its share capital. The procedure that it sets out requires shareholder approval and lodgement with ASIC, and if the procedure is not followed, any person who is involved in that non-compliance contravenes s 256D(3), which is a corporation/scheme civil penalty provision exposing the contravening party to a pecuniary penalty, a compensation order or a disqualification order.

Section 256B(1) says that a company may reduce its share capital "in a way that is not otherwise authorised by law" if the reduction complies with the requirements of Part 2J.1 Division I. The section assumes that in the absence of compliance with Part 2J.1 Division I or other authorisation, share capital cannot be reduced. Unless the new s 254T constitutes legal authority to reduce the company's share capital by paying a dividend, a dividend cannot be paid if the effect of doing so is to reduce the company's share capital, without shareholders approving the payment of the dividend under Part 2J.1 Division I. On its face, the new s 254T does not purport to authorise anything. It is cast in the negative,

prohibiting the payment of dividends unless stated conditions are satisfied. It does not say that if the conditions that it prescribes are satisfied, the payment of the dividend is authorised.

Therefore an important question is presented by the unsatisfactory drafting of the new dividend provision: is it permissible under the present law for directors to declare a dividend or determine that a dividend be paid, where the payment of the dividend has the effect of reducing the company's share capital?

A4. Some reflections on the history of the maintenance of capital rule and the profit rule

The Joint Opinion usefully traces of the history of the requirement that dividends be paid only out of profits (the **profit rule**), and the allied proposition that a dividend must not be paid if it would have the effect of reducing share capital (the **maintenance of capital rule**). As will be shown, it is important to keep the profit rule and the maintenance of capital rule conceptually separate from one another, even though they largely overlap.

The maintenance of capital rule concerning dividends is an application of the broader doctrine of maintenance of capital, which was one of the three fundamental pillars of 19th-century company law (the others being the principle of limited liability and the doctrine of *ultra vires*). When the privilege of limitation of liability was conferred on registered companies by the Limited Liability Act 1855 (UK) and then consolidated into the Joint Stock Companies Act 1856 (UK), English courts readily implied that the new system required that subscribed capital must be maintained, except to the extent that it was dissipated in pursuit of the company's trading objects, and consequently that capital could not be returned to the shareholders: *Re Exchange Banking Company (Flitcroft's case)* (1882) 21 Ch D 519; *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349; *Trevor v Whitworth* (1887) 12 App Cas 409; *Lee v Neuchatel Asphalt Company* (1889) 41 ChD 1. The doctrine of maintenance of capital, including the maintenance of capital principle, was accepted and applied in Australia: *Phillips v Melbourne and Castlemaine Soap & Candle Company* (1890) 16 VLR 111; *Davis Investments Pty Ltd v Commissioner of Stamp Duties* (1958) 100 CLR 392; *Australian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119; *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567.

The *Lachberg* case, and also *Jenkins v Harbour View Courts Ltd* [1966] NZLR 1, made it clear that the doctrine of maintenance of capital has a broad application not dependent on any particular statutory context, and is attracted whenever the effect of a transaction is to reduce share capital. The statutory procedure for reduction of capital must be satisfied if, as a matter of fact and substance, the effect of the transaction is to reduce share capital, regardless of how the parties characterise what they have done: *Redweaver Investments Pty Ltd v Lawrence Field Pty Ltd* (1991) 5 ACSR 438, 444. The statutory exceptions to the maintenance of capital principle, which eventually became Part 2J.1 of the Corporations Act, are founded on the proposition that, but for the permission they confer, share capital must be maintained and cannot be returned to shareholders.

The profit rule, that is the proposition that a dividend may be paid only out of profits, had a different historical evolution, as the Joint Opinion points out. The model articles of association under the 1856 Act included the proposition that "no dividend shall be payable except out of profits from the business of the company", a clause limited in later legislation to the company's "profits". Companies were not required to include that clause in their articles of association and if they did, the clause had effect as part of the statutory contract between the company and its members rather than as a strict statutory prohibition. That approach was continued in Australia until the Uniform Companies Act 1961: s 376, enacted a statutory version of the proposition.

Importantly, as the Joint Opinion points out, English judges treated the proper construction of the article requiring that dividends be paid out of profits as a matter of internal management for the company to resolve, and said that the courts would be reluctant to interfere: *Stevens v South Devonshire Railway Company* (1851) 9 Hare 313, 327 per Turner VC; *Lee v Neuchatel Asphalt Company* (1889) 41 Ch D 1, 22 per Lindley LJ; *Dovey v Cory* [1901] AC 477, 488 per Lord Macnaghten. However, once the evidence indicated that the effect of the distribution was to reduce share capital, the foundation for curial intervention was established. Consequently when English courts later developed the dividend rules that are set out in every textbook of company law (for example, *Ford's Principles of Corporations Law* (looseleaf), [18.150]-[18.210]), the focus of their attention was the maintenance of the company's share capital rather than the meaning of the words used in the corporate constitution.

It was not possible for Australian courts to continue that approach after the enactment of a statutory profit rule in 1961 gave them a mandatory text to construe. But by that time the dividend rules, based on the maintenance of capital rule, had been largely established, and so it was open for the Australian courts to apply those dividend rules in order to give meaning to the statutory requirement that dividends be paid out of profits, and they did so: for example, in the *Industrial Equity* case cited above, and also in *Marra Developments Pty Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616. Consequently Australian dividend law since 1961 has had a double focus, on the meaning and effect of the statutory profit rule, and on the application to dividends of the broader and more fundamental maintenance of capital rule.

The 19th century exception to the doctrine of maintenance of capital, which permitted a reduction of share capital by following a strict procedure designed to protect the interests of creditors and shareholders, was made less onerous by developments in late 20th century Australian statutory law. In particular, the Company Law Review Act 1998 introduced the provisions of Part 2J.1 Division 1, which allow a reduction of share capital by a procedure of shareholder approval and lodgement with ASIC; and the 2010 Act amended s 258F to permit a company to reduce its share capital, without cancelling shares, if paid-up share capital is lost or not represented by available assets. Importantly for present purposes, these provisions do not purport to do away with the doctrine of maintenance of capital, but instead, their foundation premise is that the doctrine continues to apply except where statutory exceptions are created.

Manifestly, the 2010 Act repealed the statutory profit rule (though not its constitutional counterpart) and replaced it with the new s 254T. However, once the history of dividend law is grasped, it becomes reasonably plain that the new s 254T operates within the context of the continuing doctrine of maintenance of capital, as applied to dividends by the maintenance of capital rule. In the absence of express provision or necessary implication to the contrary, s 254T cannot be regarded as abrogating the maintenance of capital rule and therefore cannot be seen as authorising a reduction of share capital by a method alternative to s 256B(1). The Joint Opinion expresses this conclusion emphatically (page 14):

> *The new s 254T, however, does not authorise any act: it merely prohibits some acts. A dividend may <u>not</u> be paid unless the company's assets thereafter exceed its liabilities, the dividend is "fair and reasonable" to members as a whole and creditors are not prejudiced. That is not the same proposition as that a dividend <u>may</u> be paid <u>if</u> those conditions are satisfied: just as the proposition that rain will not fall unless there are clouds overhead is not the same as the proposition that rain will fall if there are clouds overhead.*

A5. The scope of the maintenance of capital rule today

It follows from this reasoning that the 19th century doctrine of maintenance of capital, fundamental at that time, remains as a fundamental principle of company law except to the extent clearly abrogated by statute. The maintenance of capital rule, which applies the general doctrine to the payment of dividends, has survived since the 19th century and continues to be applicable to Australian company distributions today. Though fundamental to the present law, it can be abolished or further qualified. It is important to consider whether, in the current law reform context, the rule should be abandoned or modified (see the policy discussion in Part B of this paper). But it will not be abandoned or modified without clear legislation to that effect.

The maintenance of capital rule is not the same as the proposition that dividends may be paid only out of profits, though obviously if a dividend is paid only out of properly ascertained profits there is no reduction of share capital and no occasion to apply the maintenance of capital rule. The more difficult question is this: to what extent, if at all, does the maintenance of capital rule permit dividends to be paid otherwise than out of profits?

Sub-paragraphs (a)-(e) below address some questions put to Counsel by the ATO and answered in the Joint Opinion. The reasoning of the Joint Opinion is commented on and analysed. Some of the questions are said to reflect a misapprehension about accounting. That is a criticism of whoever formulated the questions - not, or at any rate not necessarily, the ATO. The ATO was endeavouring to obtain Counsel's advice so that it could respond authoritatively to questions that had been put to it. The misconceptions are likely to have been by those who raised the issues with the ATO.

(a) Current year profit, accumulated loss

The first question addressed in the Joint Opinion was this:

> *Can a company pay a dividend out of current year profits under section 254T of the Corporations Act if it has prior year losses, and/or it has net assets of a value less than share capital, without either (a) also undertaking a reduction of capital pursuant to Chapter 2J of the Corporations Act, or (b) first reducing its share capital pursuant to s 258F of the Corporations Act?*

The question envisages the following alternative circumstances:

- (i) current year profits, prior year losses, and negative net assets; or
- (ii) current year profits, no prior year losses, and negative net assets.

As a result of the repeal of the former s 254T (and assuming no constitutional provision requiring dividends to be paid out of profits), each of these alternatives must be addressed in two steps.

First, what are the restrictions imposed by the new s 254T? For both alternatives, there will be an issue about s 254T(1)(a). The fact that negative net assets exist is beside the point, as far as the application of s 254T(1)(a) is concerned. The issue under that provision is whether the value of the net assets exceeds the value of the proposed dividend. The presence or absence of prior year losses might have an impact on solvency and on whether payment of the dividend would materially prejudice the company's ability to pay its creditors, even if the company is not already insolvent and the payment of the dividend would not make it so. In all these ways, the application of the new s 254T to the circumstances envisaged by the question will depend on additional facts, and the supplied facts do not permit any answer.

Second, what is required by the maintenance of capital rule? Given that the maintenance of capital rule was developed by case law, as an application to dividends of the doctrine of maintenance of capital, we can find an answer to this question by recourse to the cases, as the Joint Opinion does.

According to the case law, a dividend may be paid out of current year profits, notwithstanding prior year losses, even if the loss for prior periods has reduced the balance of capital and reserves to an amount less than the capital subscribed; that is, company law does not require that "lost capital" be "made up" before a dividend is paid out of current year profits: *Lee v Neuchatel Asphalt Company*, at 22-23 per Lindley LJ; *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239; *Ammonia Soda Company v Chamberlain* [1918] 1 Ch 266; *Re National Bank of Wales* [1899] 2 Ch 629; *Glenville Pastoral Co Pty Ltd v Federal Commissioner of Taxation* (1963) 109 CLR 199; *Marra Developments Pty Ltd v BW Rofe*, cited above, at 630 per Mahoney JA. As an application of that principle, a company is not required to provide for the replacement of capital lost, through a depreciation in the value of a non-current asset, before a dividend may be paid.

The case law should not be taken as merely addressing the meaning of the word "profit" in a constitutional or statutory provision; rather, the cases are an elucidation of the maintenance of capital rule and, more particularly, the limits of that rule. The case law tells us that the maintenance of capital rule does not go so far as to demand restoration of the share capital account as a precondition to any distribution out of current profit.

Of course, as the Joint Opinion points out, the maintenance of capital rule will be infringed if there is no reserve of previously appropriated profit at the commencement of the current period, and the dividend exceeds the amount of profit for the current period. In those circumstances, payment of a dividend necessarily diminishes the net assets of the company to a balance less than the share capital account at the commencement of the period. The maintenance of capital rule prevents the company from appropriating to the payment of a dividend any part of the balance of the share capital account that remains after setting it against the balance of losses in earlier periods.

The correct treatment of current losses where there are profit reserves is less settled. The general rule is that if a company has transferred retained profits to a revenue reserve and subsequently suffers a loss, the loss must be written off against the revenue reserve before a dividend is paid to the shareholders: *Re John Fulton & Co Ltd* [1932] NI 35; see also *Lich v United States Rubber Co* 123 F 2d 145 (1941). If the company has a revenue reserve and there is a credit balance in its share capital account, and subsequently the company suffers a loss through an unrealised depreciation in the value of non-current assets and makes a loss reduction of capital, it must first to write off the loss against the reserves, and reduce share capital only if the reserves are insufficient to absorb the loss: *Re Barrow Haematite Steel Company* [1900] 2 Ch 846; *affd* [1901] 2 Ch 746. However, in one case it was held that a loss from depreciation in the value of a non-current asset (the company's tied houses) should be allocated to capital and reserves proportionately: *Re Hoare & Co, Ltd and Reduced* [1904] 2 Ch 298.

(b) Appropriation to an accumulated loss account or reserve

The case law permitting a dividend to be paid out of current year profits, notwithstanding prior year losses, is subject to an important qualification. Profits cease to be available for distribution as dividends if there is a binding appropriation of those profits to an accumulated loss account or reserve. The Joint Opinion cites *Fisher v Black & White Publishing Company* [1901] 1 Ch 174 on the question of appropriation of profits to a reserve.

There are some other helpful observations on the circumstances in which a fund of profits will be regarded as having been bindingly appropriated and no longer available for dividend. For example, in *Marra Developments v BW Rofe* (cited above), Mahoney JA (at 631) contemplated that a company may elect to distribute profits derived in its current trading period, or carry them to a reserve, or so treat them as, in effect, to capitalise them. His Honour seems to contemplate a clear, positive decision to appropriate the current profit, before it would cease to be available for dividend. Similarly in *Glenville Pastoral Co Pty Ltd v Federal Commissioner of Taxation* (1963) 109 CLR 199, at 207-8, the court explained that carrying an amount of profits to a reserve account does not convert it into capital, and accordingly it continues to be distributable; but on the other hand the directors may "by a positive and final decision, apply distributable profits to make good lost share capital", and in that event the fund loses its identity as a detachable fund of profit and cannot be used for dividend. In *Stapley v Read Bros Ltd* [1924] 2 Ch 1, at 5, the court asked whether, on the facts, the company had "finally and irrevocably capitalised those profits so as to disentitle themselves forever afterwards from restoring them to reserves and from dealing with them as profits?"

At a practical level, where a company with accumulated losses makes a profit for the current period, it is accepted accounting practice that, in the balance sheet as at the end of the current period, the current profit is recorded as a reduction of the accumulated losses rather than by crediting a separate profit reserve, pending a formal decision by the directors as to the application of that profit. In those circumstances there does not seem to be any "final and irrevocable" decision to appropriate the current period profit to accumulated losses, until the directors make their decision on whether to pay a dividend. If the directors resolve to pay a dividend in an amount less than the total current period profit, the balance unpaid will be treated as appropriated to the accumulated loss account and will no longer be available for dividend purposes. The position would be different if the current period profit was credited to a profit reserve rather than to accumulated losses, for then the balance not paid out in dividend would retain its character as profit available for dividend.

In TR 2012/5, paras 14, 16, the ATO expresses the opinion that if the directors approve financial statements that bring current period profits to account in an accumulated profit/loss reserve, they have not thereby irrevocably appropriated the current period profit so that it is no longer available for dividend, *provided that* at the same directors' meeting, the directors pass a legally effective resolution determining or declaring to pay a dividend out of the current period profits. This is a curious and somewhat artificial restriction. In the ATO's view a decision to approve the financial statements that is made earlier in the directors' meeting, is taken to be subject to an implied qualification allowing for partial variation by a decision in contemplation and to be made later in the meeting, but there is no such implied condition if the dividend decision is taken at a later meeting, even if the later decision is just as much in contemplation. In usual circumstances, it is clearly contemplated that there will be two relevant directors' decisions, approving financial statements and determining a dividend, and in those circumstances one would think that if the approval of the financial statements comes first, it is necessarily subject to the prospect that in their later dividend decision, the directors will adjust the accumulated profit/loss reserve by reference to the amount of the dividend. There is no distinction in substance between a case where the financial statements are approved and the dividend is determined at the same board meeting, and a case where there are separate meetings.

(c) Questions based on misunderstanding of accounting practice - asset accounts, expense accounts, negative reserve accounts

Some of the ATO's questions to counsel reflected a misunderstanding of the proper accounting practice for determination and payment of dividends. For example, the second question addressed by the Joint Opinion was as follows:

> *Can a company pay a dividend under s 254T out of asset accounts recording, for example, internally generated goodwill, brands and mastheads, etc?*

As the Joint Opinion points out, the question reflects a misconception about the process of declaring and paying a dividend. When the company pays a dividend to shareholders it disposes of an asset of the company, for example part of the balance of a company bank account. The asset account is necessarily in debit (recording something owned by or owed to the company), and the payment is recorded as a credit to the asset account. Double entry accounting requires a corresponding debit to another account. As a dividend is a payment without consideration, the debit is not to an asset account; the debit is to an equity account, such as a profit account or reserve. Even though assets are (in another sense) appropriated or resorted to in order to satisfy the shareholders' entitlement to a dividend, the payment of the dividend is not in an accounting sense charged to the asset account.

It follows that an asset account (such as internally generated goodwill, brands and mastheads) can never be regarded as the source fund "out of" which a dividend is validly declared or paid. That is a conclusion based on the proper application of accounting practice. It does not need to be justified by reference to case law, except to the extent of showing that the courts generally follow accounting practice on such matters. Of course, if assets are revalued, a separate question arises as to whether the asset revaluation account is available to support a dividend. That is considered below.

The Joint Opinion (page 21) seeks to support its conclusion about the unavailability of an asset account by referring to case law, including the observation of Lindley LJ in *Verner v General & Commercial Investment Trust* (cited above, at 266) that "a dividend presupposes a profit in some shape". With respect, that proposition, and the observation in the Joint Opinion that "a dividend is an appropriation of profits", go too far as a matter of law. As the history of the profit rule (outlined above) demonstrates, there is nothing inherent in the concept of a dividend that requires that it must be a distribution out of profits unless statute or the company constitution requires that. As far as the law is concerned, the true proposition is embodied in the maintenance of capital rule: that is, a distribution to shareholders is not permitted if it has the effect of an unauthorised reduction of share capital. As far as accounting practice is concerned, the only requirement seems to be to debit an equity account to reflect the declaration or determination of the dividend, not to require that the account to be debited must be a profit account. Importantly, there may be equity accounts (in particular, reserves) that are not profit accounts but that can nevertheless be used to support a dividend.

Some other ATO questions reflect the same misunderstanding of accounting practice. For example, the ATO asked:

> *Can a company pay a dividend under s 254T out of expense accounts (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards?*

An expense account, like an asset account, is a debit account and does not record a fund available for appropriation to pay a dividend. The idea of paying a dividend "out of" an expense account is misconceived.

Similarly, the ATO asked:

> *Can a company pay a dividend under s 254T out of negative reserve accounts (including accounts which are created and immediately debited into a negative), or other accounts with negative balances?*

In accounting terms, payment of a dividend involves a credit to the account recording the asset paid or transferred to the shareholder and a debit to the reserve account (recording the appropriation of the credit balance of the reserve). According to the Joint Opinion, an account already in debit cannot be appropriated, by posting an offsetting debit, to declaration or payment of a dividend.

Both in the case of expense accounts and negative reserve accounts, reasoning by reference to accounting practice is both necessary and sufficient to provide an answer to the questions. Unfortunately the Joint Opinion tends to cloud the position by referring, as well, to judicial pronouncements about dividends being paid only out of profits.

There is an associated but different question, namely whether a reserve account newly created in order to reflect the payment of a distribution to shareholders must be treated for company law purposes as an equity account offsetting share capital. Generally speaking, where a distribution is accounted for by the creation of a new negative account, the accounting leaves open the question of the source fund to support the dividend. If there is no available profit or other income account, the conclusion is likely to be that the distribution is to be debited to the share capital account. The situation is made more complicated where the distribution is a distribution of buy-back consideration. In that case, provided the buy-back procedure prescribed by Part 2J.1 Division 2 is satisfied, there is an authorised reduction of capital. For dividend purposes, in the absence of some available profit or income fund, must the reserve be debited to the share capital account? This question has obvious importance for taxation purposes. One would have thought the answer depends on a precise calculation of the nature of the distribution and the availability of funds to support it.

According to the ATO (TR 2012/5, para 65), there is controversy as to whether, when a debit is made to a new account producing a negative balance, regard may be had to the substance of the transaction from a company law perspective in order to determine the source of the debit. The ATO gives this account of the *Consolidated Media Holdings* case:

> *In **Consolidated Media Holdings Ltd v FCT** [2011] FCA 367; 2011 ATC 20-259, the taxpayer debited a distribution to an account entitled "Share Buy-Back Reserve Account" resulting in a debit balance in that account in circumstances where the account had never had a credit balance or credit entry. It was held by Emmett J at first instance that the reserve account was part of the company's share capital account, which was debited in the making of the distribution [although the decision arose under the analogous provisions regarding share buy-backs rather than the s 6(1) definition of dividend, the Commissioner considers the dicta of Emmett J relevant, pending the final disposition of the matter]. The decision was reversed on appeal [2012] FCAFC 36 [on a different basis to that of Emmett J] and is at the time of writing the subject of an application for special leave to the High Court. [The conclusion of Emmett J that the distribution was, as a*

> *matter of company law, a return of share capital is not, however, in contest. That conclusion the Commissioner considers relevant to the operation of para 202-45(e) of the 1997 Act].*

In the *Consolidated Media Holdings* case, the taxpayer argued, unsuccessfully at first instance, that the payment of buy-back consideration debited to the buy-back reserve account (and credited to an inter-company receivables account) was the distribution of the dividend, attracting a rebate in the taxpayer's circumstances, rather than a capital gain. Emmett J held that on the facts, the share capital account comprised both the company's shareholders' equity account and the share buy-back reserve account, although neither account was called the "share capital account".

Presumably the ATO supports Emmett J's reasoning, and it regarded the matter as "controversial" only because there was an application for leave to appeal to the High Court, which might challenge some of that reasoning.

For the time being, the position is that the correct analysis of a negative buy-back reserve depends upon close examination of the facts. However, that is now subject to appeal. After TR 2012/5 was released, the Commissioner obtained special leave to appeal, and the appeal is to be heard in the week of 6 November 2012.

According to the written submissions before the High Court, which can be found at http://www.hcourt.gov.au/cases/case_s228-2012), the issues in the case relate to the construction and application of s 159GZZZP and s 6D, rather than, directly, any question of company law. The submissions raise directly the question whether the "share buy-back reserve" is properly to be regarded as part of the company's "share capital account" as defined in the income tax legislation, in circumstances where the company had for practical purposes no profits and its only equity account was its subscribed capital account. It remains to be seen whether the High Court will employ company law concepts in analysing the questions before it. The written submissions touch on some company law questions in passing (Appellant's submissions, para 56; Respondent's submissions, para 57, and see paras 16-20).

(d) Asset revaluation reserve

Prior to the introduction of IFRS in Australia, the Australian accounting standards had the effect that all recognised changes in the value of trading stock were required to be brought to account to ascertain the amount of operating profit or loss. It was not permissible to set aside, as a distributable fund of profits, an unrealised increment in the value of some trading stock, while treating a fall in the value of other trading stock as part of the calculation of trading profit or loss. However, when a non-current or "capital" asset was revalued, the increase in value was credited to a revaluation reserve, an equity account. In that context, could a dividend be appropriated as the source fund for declaration and payment of a dividend (where, of course, the dividend entitlement will be satisfied by resorting to an asset such as a bank account, or by borrowing)?

There is some inconsistent case law on this question in the United Kingdom. *Westburn Sugar Refineries Ltd v Inland Revenue Commissioners* [1960] SLT 297 gave a negative answer. However, in *Dimbula Valley (Ceylon) Tea Company v Laurie* [1961] 1 All ER 769, Buckley J answered the question in the affirmative, provided there is a sufficient surplus on the balance of all accounts (the ***Dimbula Valley* principle**). That approach was accepted as correct in *Australian Oil Exploration v Lachberg* (cited above, at 133), by Mason J in *Industrial Equity Ltd v Blackburn* (cited above, at 580), and (in effect) by the High Court in *Federal Commissioner of Taxation v Sun Alliance Investments Pty Ltd (In liq)* (2005) 225 CLR 488. The issue seems to be no longer controversial, as a matter of Australian law. However, as

Barrett J remarked in *Heesh v Baker* (2008) 67 ACSR 192; [2008] NSWSC 711, especially at [43], profits might not be profits available for dividend if and to the extent that good practice or adherence to accounting standards requires that some part of profits (such as an unrealised surplus on revaluation of assets) be carried to a reserve.

The *Dimbula Valley* principle is best regarded as affirming that the declaration and payment of a dividend does not offend the maintenance of capital rule. On that basis, the case law survives the enactment of the new s 254T, although since the commencement of that provision, the lawfulness of the dividend depends not only on there being no reduction of share capital involved, but also on satisfaction of the new statutory tests regarding the balance sheet, fairness to shareholders and absence of material prejudice to creditors. Since the repeal of the old s 254T (and assuming no constitutional requirement for dividends to be paid out of profits), the question addressed by the *Dimbula Valley* principle is not about the meaning of "profit" in some statutory or constitutional context, but instead it is about whether, in the absence of current profits or an available profit reserve, a distribution debited to an asset revaluation reserve necessarily constitutes an unlawful reduction of share capital.

It is puzzling that, having previously concluded that the new s 254T does not authorise any act because of its negative language, the Joint Opinion takes the position that the new s 254T has resolved the inconsistency between *Westburn Sugar Refineries* and *Dimbula Valley* in favour of the latter:

> *Provided that the conditions in the new section are met, the fund recording unrealised profit can be appropriated to the payment of dividends - although it must be the case that the revalued assets truly have the allocated value, so that the solvency requirement of the new section is satisfied.*

The qualification about solvency is important and, with respect, correct. But it is difficult to see how a section cast in negative language can be said to have confirmed the correctness of one view of the maintenance of capital rule over an alternative view of its application to dividends paid out of an asset revaluation reserve.

In a more limited respect the new s 254T confirms the *Dimbula Valley* principle. The requirement that, for an asset revaluation reserve to be used to support a dividend, there must be a sufficient surplus on the balance of all accounts, is reinforced by s 254T(1)(a), which requires that there must be an excess of assets over liabilities sufficient for the payment of the dividend. To this extent the maintenance of capital principle and the new s 254T overlap.

(e) Impact of IFRS

There is a question whether the legal analysis presented above, and in the Joint Opinion, might have been superseded by the Australian adoption of International Financial Reporting Standards. The case law upon which the legal analysis relies was decided either in the context of pre-IFRS accounting standards or prior to the adoption of the system of accounting standards. Under pre-IFRS accounting standards, unrealised profits were booked to the balance sheet without being taken through the profit and loss statement, and capital profits had to be taken through the profit and loss statement as extraordinary items.

Taxation Ruling TR2012/5 comments as follows:

> 28. *Movements in asset values that are now recognised as other comprehensive income were not always previously recognised. Under present accounting standards, the distinction between capital profits and trading profits is no longer uniformly required. Certain unrealised capital profits (such as a gain on disposal of a capital asset) are recognised as profits in the statement of financial performance.*
>
> 29. *The links between the doctrines of capital maintenance and profits in the Corporations Act were previously more explicit, as were the links between the Corporations Act and the Taxation Acts, in respect of concepts such as share capital and profits. The changes resulting from the introduction of the International Financial Reporting Standards (IFRS) in 2005 were recognised by ASIC and the AASB as affecting the payment of dividends by corporate entities.* [citing Australian Accounting Standards Board, *IFRS and distributable dividends*, 31 October 2005; Australian Securities & Investments Commission, *ASIC clarifies impact of IFRS on dividends*, IR 05-57, 5 October 2005]

The Australian adoption of IFRS does seem to have an impact on the issues raised in the Joint Opinion, particularly around revaluation of assets. What follows is a brief summary of current AIFRS accounting standards relating to the determination and presentation of asset revaluations.

Under the current AASB 101, a set of financial statements is required to include:

(a) a statement of profit or loss and other comprehensive income for the period;
(b) a statement of financial position at the end of the period (previously described as a balance sheet); and
(c) a statement of changes in equity for the period (AASB 101, at 10).

The statement of changes in equity for the period discloses changes arising from profit or loss, other comprehensive income, and dividends (AASB 101, at 106 and 107). "Profit or loss" is defined in AASB 101 as the total of income less expenses excluding the components of "other comprehensive income".

AASB 101 defines "other comprehensive income" as comprising items of income and expenses that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards. The components of other comprehensive income include:

(a) changes in revaluation surplus (see AASB 116 *Property, Plant and Equipment* and AASB 138 *Intangible Assets*);
(b) actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93A of AASB 119 *Employee Benefits*;
(c) gains and losses arising from translating the financial statements of a foreign operation (see AASB 121 *The Effects of Changes in Foreign Exchange Rates*);
(d) gains and losses on remeasuring available-for-sale financial assets (see AASB 139 Financial Instruments: Recognition and Measurement); and
(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge (see AASB 139).

AASB 101 (at 10, 81A) requires that the items of other comprehensive income be brought into account in the entity's statement of profit or loss and other comprehensive income, although it allows for the statement to be in two parts, addressing profit or loss and then bringing to bear other comprehensive income.

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs must be revalued (AASB 116, at 36). A class of property, plant or equipment is a grouping of assets of a similar nature and use in the entity's operations, such as land, machinery, motor vehicles, furniture and fittings, or office equipment (AASB 116, at 37).

If an asset's carrying amount has increased as a result of a revaluation, the increase must be recognised in other comprehensive income and accumulated in equity under the heading "revaluation surplus". However, the increase must be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss (AASB 116, at 39).

If an asset's carrying amount is decreased as a result of a revaluation, the decrease must be recognised in profit or loss. However, the decrease must be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading "revaluation surplus" (AASB 116, at 40).

There are two important consequences of the adoption of AIFRS, as far as the previous case law is concerned. First, the current accounting standards require that if an asset is revalued, the entire class of assets to which it belongs must be revalued, but the revaluation can be limited to that class. Second, a revaluation that increases the carrying amount of an asset is required to be recognised in "other comprehensive income" and accumulated in equity as a revaluation surplus, unless the increase reverses a revaluation decrease that has previously been recognised in profit or loss.

(f) Other comprehensive income

The ATO asked:

> *Can a company pay a dividend under s 254T out of accounts for items of "other comprehensive income" within the meaning that term has in AASB 101 "Presentation of Financial Statements" that are not otherwise "profits"?*

The question whether accounts reflecting these items, or any of them, are available to support a dividend is a matter of some importance. The Joint Opinion says that the amount standing to the credit of an income account is not, *per se*, available for dividend. This is on the basis that income is a component in the calculation of profit, and it is only profit which can be divided and paid as dividends (again citing Lindley LJ's observation in *Verner v General & Commercial Investment Trust* that "a dividend presupposes a profit in some shape"). But if (as contended here) Lindley LJ's reasoning in *Verner's* case is not about the profit rule or the inherent nature of the concept of a dividend, and is better understood as an application of the maintenance of capital rule, the absolute proposition that only profit can be divided and paid as dividends ceases to be compelling. A distribution by way of dividend can be made, provided that the effect of doing so is not to reduce share capital. When we come to consider "other comprehensive income", the possibility of divergences between the outcome produced by the maintenance of capital rule, and the outcome produced by applying the profit rule, the proposition that only profit can be paid as dividends, becomes real.

The Joint Opinion's conclusion of other comprehensive income is as follows:

> *In short, neither gross income nor gross expenses ("comprehensive" or not) can be appropriated to pay dividends. If there is a surplus of "other comprehensive income" over "other comprehensive expenses", and save so far as there is a concurrent loss recognised under the accounting standards, surplus is - if the entries to the "other comprehensive income" accounts record something which has happened rather than mere notional applications - a profit which should be available for dividend. But it is not necessarily so: it depends on the extent of any correlation between the accounting entries and objective reality.*

That conclusion is not quite what one would expect from the reasoning that precedes it. If a dividend can be paid only out of profits, one would expect the Joint Opinion to insist that the two parts of the statement of profit or loss and other comprehensive income must be combined, and the amount available for dividend be calculated by adding together the surplus (or deficiency) of income over expenditure in both parts of the statement, or setting of a surplus in one part against a deficiency in the other part. But the passage quoted seems to accept that unless there is a concurrent loss recognised under the accounting standards, net other comprehensive income could be available for dividend, and perhaps as importantly, available to be accumulated in equity to support a dividend in a later year. As the Joint Opinion says, the outcome depends upon the extent of any correlation between accounting entries and "objective reality". In other words, one has to understand the precise facts and circumstances relating to the surplus and the creation of the reserve.

AASB 101 (para 82A) envisages that some items of other comprehensive income will be reclassified subsequently to profit or loss, while other items will not. It may be that where an item of other comprehensive income is to be reclassified to profit or loss, it would be inappropriate to treat it as an account to which payment of a dividend can be allocated in the meantime. Where, however, an item of other comprehensive income is of a kind that will not be reclassified subsequently to profit or loss, its availability to support a dividend might be a more open question.

In the result, the availability of an other comprehensive income account to support a dividend will depend upon a factual analysis. That is hardly a satisfactory outcome, in terms of clarity and guidance. As the ATO points out (TR 2012/5, para 66), if in the particular facts the dividend is purportedly but not lawfully sourced in an other comprehensive income account, there is a misappropriation of the company's assets, which is not a dividend to be taxed as an assessable income of resident shareholders, and will be taxed as return of share capital under the CGT provisions.

A6. Some brief notes on tax issues

The company law principles outlined in the Joint Opinion, and discussed above, have been taken by the ATO to have a direct application to the frankability, and assessability for income tax, of certain corporate distributions:

> *The adoption (for some purposes) of a criterion for the taxation of shareholders which is "that of the company law" has the consequence that the effect of a transaction between company and shareholders as a matter of company law may be relevant to, or even determination of, the liability to income tax of the shareholder in respect of the dividend.* (TR 2012/5, para 21)

It is not appropriate, in this paper, to dig deeply into the tax law, but an understanding of the correlation between company law and tax outcomes is a prerequisite for sensible law reform, because little is achieved if (for example) the profit rule is repealed as a matter of company law, if it is only distributions out of profit that are frankable and assessable as dividends.

Section 202-45 of the Income Tax Assessment Act 1997 (Cth) states that certain items are unfrankable distributions. One of those items (subparagraph (e)) is "a distribution that is sourced, directly or indirectly, from a company's share capital account". The word "distribution" is, in relation to companies, defined in s 960-120 to mean "a dividend, or something that is taken to be a dividend, under this Act".

Section 44(1) of the 1936 Act includes in the assessable income of a shareholder in a company (whether the company is a resident or non-resident), in the case of a resident shareholder, dividends that are paid to the shareholder by the company out of profits derived by it from any source, and in the case of a non-resident shareholder, dividends paid to the shareholder out of profits derived from sources in Australia. Section 44(1A) extends the operation of the section to a dividend paid out of amount other than profits, declaring that such a dividend is taken to be paid out of profits.

Section 6 of the Income Tax Assessment Act 1936 (Cth) defines "dividend" to include:

(a) any distribution made by a company to any of its shareholders, whether in money or other property; and
(b) any amount credited by company to any of its shareholders as shareholders;

but does not include:

(d) moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders ... , where the amount of the money is paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company.

Section 975-300 of the 1997 Act provides:

(1) A company's ***share capital account*** is:
    (a) an account that the company keeps of its share capital; or
    (b) any other account (whether or not called a share capital account) that satisfies the following conditions:
        (i) the account was created on or after 1 January 1998;
        (ii) the first amount credited to the account was an amount of share capital.
(2) If the company has more than one account covered by subsection (1), the accounts are taken, for the purposes of this Act, to be a single account.

Generally, a share capital account that has been tainted under Division 197 of the 1997 Act will not be considered a share capital account for the purposes of taxation law, except in circumstances provided for in s 975-300(3) of the 1997 Act. Consequently, a distribution debited to a tainted share capital account will be a dividend, as the exception in s 6(1)(d) of the 1936 Act will not apply to tainted accounts which are not regarded as share capital account. However, under para 975-300(3)(ba) of the 1997 Act, para 202-45(e) applies to render a distribution unfrankable even if the distribution is sourced directly or indirectly in a tainted share capital account. In summary, if the company has a tainted share capital

account, a distribution debited to that account will be a dividend which is assessable income, but it will be unfrankable.

The definition of "share capital account" brings into consideration the concept of share capital for company law purposes, as a criterion for taxation. The definition requires consideration of whether the company distribution has been debited to amounts standing to the credit of the company's share capital account, and that in turn requires consideration of what the company has done with its share capital as a matter of accounting and for company law purposes. In the result, as a general proposition a return of capital for company law purposes that is debited to amounts standing to the credit of a share capital account, as defined, is excluded from taxation as a dividend for income tax purposes: see TR 2012/5. A return of capital that is not a dividend, as defined, is also not a "distribution" for tax purposes, and therefore it is not a frankable distribution. Generally speaking, it will be taxed as a return of capital under the CGT provisions.

TR 2012/5 (para 24) contemplates that a distribution may be a return of share capital for company law purposes, and yet not be debited to amounts standing to the credit of the share capital account, or perhaps debited only in part to such an account. In such a case, the distribution falls within the definition of "dividend" in s 6, and is included in the assessable income of a shareholder (subject to residence etc) under s 44(1A) as it is a dividend paid out of amount other than profits, and is taken to be paid out of profits. Therefore the dividend is a "distribution", but it is not a frankable distribution if, under para 202-45(e), if it is sourced directly or indirectly from the company's share capital account.

The ATO advances two broad propositions in TR2012/5 (para 25), namely:

(1) a dividend paid by a company, or a distribution distributed by company, as defined to the taxation purposes, will not be directly or indirectly sourced in the company's share capital account when it is lawful division of profit for company law purposes, and hence not a return of capital for company law purposes (whether authorised or unauthorised); and

(2) a return of capital for company law purposes will be sourced in the company's share capital account even if it is a dividend or distribution for tax purposes.

These foundational tax principles emphasise the importance of determining when a corporate distribution, even if it complies with new s 254T, is in effect a reduction of capital for company law purposes. The ATO, following the Joint Opinion, embraces the proposition that if the distribution is a lawful division of profit for company law purposes, it cannot be a return of capital. That should be seen as leaving open the question whether, and if so in what circumstances, a distribution not made out of profit but rather out of an equity reserve other than the share capital account, can be a lawful dividend for company law purposes. If, as contended for here, company law limits the payment of dividends by the application of the maintenance of capital rule, rather than the profit rule, there is a real prospect that some equity reserves may support a lawful dividend, and consequently a prospect that such a dividend will be (rebatable) assessable income of resident shareholders, and potentially frankable.

However, the ATO (following the Joint Opinion) adopts the view that for the purposes of the Corporations Act and company accounting, dividends can only be paid from profits and not from amounts other than profits: TR 2012/5, para 36. For reasons given above, that is an unnecessarily restricted view of company law. But the ATO concedes (para 37) that if, contrary to its view, a dividend can be paid out of an "amount other than profits" and the distribution satisfies the definition of dividend other s 6, the dividend is frankable because it is not sourced directly or indirectly from the company's share capital

account, provided the company's net assets exceed its share capital by at least the amount of the dividend, and the dividend is assessable income of its resident shareholders as a result of the deeming in s 441A.

Taxation Ruling TR 2012/5 addresses whether two specific kinds of corporate distribution are unfrankable under para 202-45(e) of the 1997 Act, which applies when the distribution is sourced, directly or indirectly, from the company's share capital account.

According to the Taxation Ruling, para 202-45(e) does not prevent a company from franking:

(a) a dividend paid to its shareholders out of profits recognised in the company's accounts and available for distribution, and paid in accordance with the company's constitution and without breaching s 254T or Part 2J.1, merely because the company has unrecouped accounting losses accumulated in prior years or has lost part of its share capital; and

(b) a dividend paid to its shareholders out of an unrealised capital profit of a permanent character recognised in its accounts and available for distribution, provided the company's net assets exceed its share capital by at least the amount of the dividend, and the dividend is paid in accordance with the company's constitution and without breaching s 254T or Part2J.1.

The Joint Opinion is to the effect that in these two cases, payment of the dividend will not necessarily contravene Part 2J.1 because (in effect) the maintenance of capital rule permits the dividend is to be paid, and new s 254T will need to be complied with on the facts but is not necessarily contravened. The Taxation Ruling says that in each case the dividend will be assessable income of the company's resident shareholders under s 44(1)(a) of the 1936 Act.

However, according to the Taxation Ruling, para 202-45(e) prevents the franking of a distribution paid by a company to its shareholders, where the distribution is a reduction or return of share capital, including an unauthorised reduction or return of share capital that does not comply with s 254T or Part 2J.1, even if it is labelled as a dividend. The distribution will be taxed as a capital gains tax event under the CGT provisions, or will be taxed as an assessable unfranked dividend, depending on the circumstances.

PART B: COMPARATIVE LAW, POLICY AND LAW REFORM

B1. Comparative law

We considered a comparative analysis of a range of jurisdictions as set out in the schedule attached to this paper. In broad terms, comparable jurisdictions can be summarised in the following way:

	Profits test	Balance sheet test	Solvency test
New Zealand	No	Yes	Yes
United Kingdom	Yes	Yes	Not specifically
Germany	Yes	No	Not specifically
Canada	No	Yes	Yes
Delaware	Yes	No	Not specifically
US Model Business Corporation Act	No	Yes	Yes
Hong Kong	Yes	No	Not specifically
China	Yes	No	Not specifically
Cayman Islands	Yes	No	Yes
South Africa	No	Yes	Yes

We draw the following conclusions based on the comparative analysis:

(i) there is a broad split in other jurisdictions between the profits test and a balance sheet test;
(ii) no jurisdiction has neither a profits test nor a balance sheet test.;
(iii) no jurisdiction has both a profits test and a balance sheet test;
(iv) the balance sheet tests are broadly split between financial statement and realizable value concepts; and
(v) we have not identified a good model for reform having regard to the policy considerations that we outline below.

B2. Policy and law reform

The following commentary is drawn from the Law Council of Australia submission to Treasury dated 7 February 2012.

The main policy driver given for the change to the dividend rules is the need for such rules to be aligned with current accounting principles after Australia adopted the IFRS. The Explanatory Memorandum notes that Australian accounting standards are increasingly linked to fair value (whether realised or unrealised), which may impact on the profitability of the company. This means that whilst a company may have sufficient cash to pay a dividend to shareholders, it may be unable to do so, as the accounting profits of the company have been eliminated by non-cash expenses.[1] This means that both the historic concept of "profit" and the disclosed net assets in the financial statements of a company may no longer be a reliable indicator of whether or not it is prudent for a company to make a distribution to its shareholders.

[1] Many attribute the reform to dividend rules to the growing irrelevance of the capital maintenance doctrine, which is explained in Part A4 of this paper.

It is argued that the capital maintenance doctrine is outdated, as evidenced by the abolition of both "par value" shares and the need for court approval for capital reductions. The solvency test was introduced into Chapter 2J of the Corporations Law as a result of the Second Corporate Law Simplification Bill.[2] At that stage, there was no commentary which specifically outlined the reasoning behind the move to the solvency test. The introduction of a solvency-based test for paying dividends is consistent with the trend of departing from the capital maintenance doctrine, and is also in line with the reforms in common law jurisdictions such as New Zealand and Canada (see Part B1 of this paper). It should be noted that New Zealand retains a balance sheet test based on financial statements that continues to introduce the accounting principle concern noted above.

A number of commentators[3] have expressed scepticism as to the effectiveness of the capital maintenance doctrine in protecting creditors. This is because the pool of funds to which creditors have recourse does not necessarily equate to the financial resources available to a company to meet the needs of its creditors. They also argue that the primary source of creditor protection under the legislation will be the deterrent effect of personal director liability for allowing the company to trade whilst insolvent under section 588G.

While not expressly stated as a policy driver in the Explanatory Memorandum, the change to the dividend rules appears to be a response to the view that a solvency test would better protect creditors than the capital maintenance doctrine.

(a) Ambiguous aspects of new s 254T

As set out in Part A3 of this paper, there are a number of ambiguities created by the adoption of new s 254T. In our view, those ambiguities are unsatisfactory and support the adoption of a new approach. Set out below is a catalogue of the more significant of those ambiguities. Any reform should deal with these ambiguities.

The scope of "assets and liabilities"

Many have argued that new s 254T should define what constitutes the "assets and liabilities" of the company, particularly on the question of whether contingent liabilities are to be included.[4]

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[2] See the Exposure Draft, Volume 2, June 1995.

[3] For example, Factor, L. *Capital Maintenance: Simplification and Creditor Protection* (1995) 5 Australian Journal of Corporations Law 259; Armour, J. *Legal Capital: An Outdated Concept? Euro Business Organisation Law Review* (2006) 7:1:5-27.

[4] *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC is the most recent authority on whether contingent liabilities constitute a "debt" and should therefore be included in determining whether a company is solvent. This is a case on whether directors breached insolvent trading prohibition under s 588G, when it entered into forward purchase agreements under which no recognisable debt or ascertainable amount was payable.

The court importantly distinguished between contingent liability to pay an unliquidated sum and contingent liability to pay a liquidated sum. Only the latter constitutes "debt" for the purposes of s 95A. In its reasoning, it distinguished *Hawkins v Bank of China* (1992) 26 NSWLR 562 which held that a contingent liability could be included as debt on the basis that:

> *"the guarantee executed by the company in Hawkins subjected it to a conditional but unavoidable obligation to pay a sum of money at a future time. The contingent liability incurred by the company in executing the guarantee was thus for a liquidated amount rather than damages for breach of contract ... in the present case the exposure of David Kidd Grain Trading Pty Ltd under its futures trading in white cottonseed did not give rise to a contingent liability to pay a liquidated sum. The exposure consisted of insufficient forward purchase contracts to meet forward sales obligations ... thus the prospect that the company would sustain a loss in the future on its dealings in white cottonseed, did not, in my view, constitute a debt for the purposes of the Corporations Act 2001 (Cth), s95A when the company's solvency or insolvency had to be considered." (per Gzell J)*

New Cap Reinsurance Corporation Ltd (in liq) and Another v AE Grant & Others [2008] NSWSC 1015 affirmed this principle, and held that a company's liabilities to indemnify reinsureds could be taken into account as contingent debts

Accordingly, it is unlikely that contingent liabilities for unliquidated sums will be included when determining whether the company's assets exceed its liabilities for the purposes of the new dividend rules.

Fair and reasonable to the company's shareholders as a whole

The requirement that the payment of the dividend must be "fair and reasonable to the company's shareholders as a whole" raises two questions.

The first question is whether the requirement restricts directors from issuing shares with preferential dividend rights. Under s 54W(1), each share in a class of shares in a public company has the same dividend rights unless the constitution provides otherwise or the company passes a special resolution approving otherwise. Under s 254W(2), which is a replaceable rule, the directors may pay dividends as they see fit, subject to the terms of issue of the shares. Therefore, there is a question as to whether directors of public companies can issue shares with preferential dividend rights even if their constitution enables them to do so, and also whether directors of proprietary companies can issue shares with preferential dividend rights as they "see fit".

The second question is a more general one about what constitutes "fair and reasonable to shareholders as a whole". An understanding of the content of this requirement may assist in answering the first question. The Explanatory Memorandum to the Company Law Review Act 1997 (Cth) (**1997 Explanatory Memorandum**), which introduced the "fair and reasonable to shareholders as a whole" test in share capital reductions, may offer guidance.

Paragraph 12.24 of that Explanatory Memorandum states that the test should be viewed as a "composite requirement" and the factors to be considered include:

(i) the adequacy of consideration; and
(ii) whether some shareholders are deprived of their rights (for example, by stripping the company of funds that would otherwise be available for distribution to preferential shareholders).[5]

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provided that it is for a liquidated amount. The Supreme Court of New South Wales suggested that the following principles are relevant when determining the question of solvency under s 95A:

"it is legitimate to use hindsight;

(a) although the words "as an when they become due and payable" require looking into the future, usually only the reasonably immediate future, the inquiry depends on the type of case with which the court is concerned; and

(b) contingent or prospective debts should be taken into account."

[5] Some specific case examples are *Re George Raymond Pty Ltd* (2000) 18 ACLC 85, which held that adverse taxation consequences for some shareholders does not constitute unfairness or unreasonableness. *Winpar Holdings Limited v Goldfields Kalgoorlie Ltd* (2002) 20 ACLC 265 held that the pro rata distribution of head office cost cuts to both departing shareholders and remaining shareholders was not "unfair and unreasonable". This is even though it meant that the value of the shares of remaining shareholders was higher than the value of shares of the departing shareholders whose shares were being cancelled. The court reasoned that:

"if the special benefits are of such unique value that they should lead to the minority shareholders receiving more than a pro rata proportion, it may be that it would be fair and reasonable for a greater than pro rata proportion of that special value to be attributed to the shares of the minority. However, there is nothing in the facts before me which indicates that any special value is other than the normal advantages of having a wholly owned subsidiary as against partial ownership ... the advantage is an advantage to the acquiring majority, but it is also an advantage to the acquired minority in that, on acquisition, they obtain an enhanced price for their shares. There is no necessary unfairness or unreasonableness if the advantage is shared. "

Interaction with Part 2J of the Corporations Act

There is substantial doubt as to whether 254T permits an authorised reduction of share capital without satisfying the requirements of Part 2J, particularly the requirement to obtain shareholder approval. This is because an ambiguity arises since, although the Explanatory Memorandum suggests that the new provision is to operate as an exception to the maintenance of capital rules, the provision is drafted as a prohibition on payment of a dividend unless the three tests are met.

There are divergent views on this issue. For example, as outlined in Part A above and the Joint Opinion it is clear that a reduction of capital must still comply with the statutory procedure and protections.

Companies and their advisers should not be put in the position of having to take a view on this important issue (with potentially serious consequences if they are wrong) when it can be easily clarified by inserting a note into the section clarifying the inter-relationship between the operation of the dividends test and the capital maintenance provisions.

(b) Practical implications of new s 254T

In addition to legal ambiguities about how s 254T should apply, there are also practical implications of the reform such as additional costs for small proprietary companies which may need to engage accountants to determine their assets and liabilities.

One issue is the use of the word "declared" in the requirement "the assets and must exceed its liabilities immediately before the dividend is declared", as outlined above. As a practical matter, companies generally "determine" dividends, because a declaration of a dividend becomes a debt owing to the shareholders at the time it is declared rather than the payment date (see section 254V(2)). Indeed, some companies do not have a power in the constitution to allow directors to declare a dividend.

Furthermore, although the potential for personal director's liability for insolvent trading may afford creditors protection, the requirement for solvency confirmation may deter directors from paying dividends.

(c) Law reform

To address the issues identified in this paper, in response to the Treasury Discussion paper referred to in the introduction to this paper the Business Law Section of the Law Council of Australia made submissions to Treasury in response to the Treasury Discussion Paper which supported the adoption of a solvency test and the deletion of the balance sheet test. The benefits of adopting a solvency test include:

(i) it provides a high level of comfort to directors in complying with their obligation under s 588G to prevent insolvent trading by the company;

It can be seen from both the *Re George Raymond Pty Ltd* and *Winpar Holdings Limited* decisions that "fairness and reasonableness" does not require equal treatment of shareholders. Rather, the focus was on whether the capital reduction reduced any rights attached to a particular class of shares. Unless the terms of issue state otherwise, ordinary shareholders generally do not have rights to a dividend. As such, an issue of shares with preferential dividend rights arguably do not deprive such shareholders of their "rights". Therefore, the "fair and reasonable to shareholders as a whole" requirement arguably does not restrict directors from issuing shares with such preferential rights.

(ii) it provides certainty, reliability and objectivity in determining whether a company's assets will exceed its liabilities following the declaration of the dividend;

(iii) it inserts in the Corporations Act a mechanism for reducing the regulatory burden on those companies that are not required to prepare financial statements; and

(iv) it would bring Australian law broadly into line with New Zealand (without the difficulty caused by a balance sheet test).

The Committee drafted the following provision to achieve the objective of adopting a solvency test:

> A company may pay a dividend on its share capital.[1 2]
>
> [1] Subject to the solvency test (see section 95A).
> [2] A dividend which involves a reduction of capital is authorised by law.

B3. Conclusions

Based on Part A of this paper and the Joint Opinion, there is a compelling need to both amend s 254T by adopting a solvency test and to resolve the uncertainties that currently exist by making it clear that a dividend which might otherwise involve a reduction of capital is authorised by law.

Having reflected on the analysis in Part A of this paper, the analysis of this paper by Mr AH Slater QC we would repropose a formulation of s 254T as follows:

> A company may pay a dividend on its share capital provided that following payment it is solvent [1 2 3]
>
> [1] Subject to the solvency test (see section 95A).
> [2] Dividends need not be paid out of profits.
> [3] A dividend which involves a reduction of capital is authorised by law.

We also support the comments by Mr AH Slater QC as to the desirability of a reconception and redrafting of Chapters 2H, 2J and parts of 2M. However, there is more pressing need to repair s 254T in the short term.

Schedule – Comparative analysis

1. New Zealand

Legislation	*Companies Act 1993* (NZ), sections 4 and 52
Actual section wording (emphasis added)	Section 52: "*(1) The board of a company that is satisfied on reasonable grounds that the company will,* ***immediately after the distribution****, satisfy the* ***solvency test*** *may, subject to section 53 and the constitution of the company, authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit.* *(2) The directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion.* *(3) If, after a distribution is authorised and before it is made, the board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy the solvency test, any distribution made by the company is deemed not to have been authorised.* *(4) In applying the solvency test for the purposes of this section and section 56,—* *(a) debts includes fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made (except where that fixed preferential return is expressed in the constitution as being subject to the power of the directors to make distributions), but does not include debts arising by reason of the authorisation; and* *(b) liabilities includes the amount that would be required, if the company were to be removed from the New Zealand register after the distribution, to repay all fixed preferential amounts payable by the company to shareholders, at that time, or on earlier redemption (except where such fixed preferential amounts are expressed in the constitution as being subject to the power of directors to make distributions); but, subject to paragraph (a), does not include dividends payable in the future.* *(5) Every director who fails to comply with subsection (2) commits an offence and is liable on conviction to the penalty set out in section 373(1).*"
Test	Section 4(1) (emphasis added): "*For the purposes of this Act, a company satisfies the solvency test if—*

	(a) *the company is **able to pay its debts as they become due** in the normal course of business; and* (b) *the **value of the company's assets is greater than the value of its liabilities**, including contingent liabilities."* Section 254T(1)(a) of the Corporations Act 2001 (Cth) adopts the New Zealand (1)(b) balance sheet test.
History of the provision and legislation	Introduced in the 1990 legislation, this test emulates the two-pronged solvency test in section 6.40(d) of the United States Model Business Corporation Act and section 42 of the *Canada Business Corporations Act*, RSC 1985, c. C-44,. "Realisable value" of assets, found in 42(b) of the Canadian legislation but not the Model Business Corporation Act, was removed from the 1993 Act.
Criticisms	
Distribution or dividend?	Distribution
Out of profits?	No prohibition – would allow distribution otherwise than out of profits if dual solvency test satisfied.
Relationship with accounting standards	Section 4(2) provides that in determining whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors: (a) **must** have regard to: (i) the most recent financial statements of the company that comply with section 10 of the *Financial Reporting Act 1993* (NZ); and (ii) all other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities; (b) **may rely on valuations** of assets or estimates of liabilities that are **reasonable in the circumstances.** This was adopted from the United States Model Business Corporation Act. "Must" has been amended from "may" in section 4(2)(a), making it more stringent than the 1990 provision.
Positive or negative language?	Positive language

2. United Kingdom

Legislation	*Companies Act 2006* (UK), Part 23 sections 830 and 831
Actual section wording (emphasis added)	Section 830(1) and (2): "*(1) A company may only make a distribution* ***out of profits*** *available for the purpose.* *(2) A company's profits available for distribution are its accumulated,* ***realised profits****, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.*" Section 831(1): "*A public company may only make a distribution—* *(a) if the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves, and .* *(b) if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.*"
Test	Statutory profits test must be satisfied in addition to common law rules that dividends must not be paid out of capital and directors must have regard to company's best interests. The test is based on the distribution pool available for paying dividends, rather than setting preconditions as to when a dividend can be paid.
History of the provision and legislation	Introduced as sections 263 and 264 of the *Companies Act 1985* (UK). No change to these sections was made by *Companies Act 2006* (UK). The old New Zealand solvency test contained similar wording, until the New Zealand reforms took their lead from the approach in Canada and the United States Model Business Corporation Act.
Criticisms	Companies with past losses, whether realised or (for public companies) unrealised, may be unable to pay dividends (especially with the practice of writing off goodwill). Reduce profits / distributable reserves in many cases, particularly because of accountings changes in relation to retirement benefits and deferred tax. For public companies – mixed use of terms 'net assets' and 'share capital and reserves' makes it unclear what section 831 adds to section 830. It appears possible to 'artificially' convert an unrealised profit into a realised one eg. via intra-group transactions.
Distribution or dividend?	**Distribution** Widely defined in section 829(1) of the legislation as "*... every description of distribution of a company's assets to its members, whether in cash or otherwise*".

	Specific exclusions for issue of bonus shares, certain reductions of capital, redemption/purchase or own shares and distribution upon winding up. For public companies, liabilities and undistributable reserves are defined in section 831(3) and (4).
Out of profits?	Prohibitive – only out of profits. The distribution rules also authorise certain transactions (some of which were previously unlawful) provided they are made out of distributable profits (eg. financial assistance / purchase / redemption of company's own shares).
Relationship with accounting standards	Test requires assessing when profits are 'realised' in accordance with **principles generally accepted at the time accounts are prepared.** Accounting rules now require provisions to be made for depreciation of fixed assets, so dividends are restricted accordingly.
Positive or negative language?	Positive language

3. Germany

Legislation	§58(4) Aktiengesetz (public companies act) §29(1) GmbHGesetz (private companies act)
Actual section wording (emphasis added)	§58(4) Aktiengesetz: *"Die Aktionäre haben Anspruch auf den* ***Bilanzgewinn****, soweit er nicht nach Gesetz oder Satzung, durch Hauptversammlungsbeschluß nach Absatz 3 oder als zusätzlicher Aufwand auf Grund des Gewinnverwendungsbeschlusses von der Verteilung unter die Aktionäre ausgeschlossen ist."* English translation: *"The shareholders shall be entitled to receive* ***distributable profit*** *to the extent such profit is not excluded from distribution to shareholders by law, the articles, a resolution of the shareholders' meeting pursuant to (3) or because such profit constitutes an additional expense pursuant to the resolution on the appropriation of profits."* §29(1) GmbHGesetz: *"Die Gesellschafter haben Anspruch auf den* ***Jahresüberschuß*** *zuzüglich eines Gewinnvortrags und abzüglich eines Verlustvortrags, soweit der sich ergebende Betrag nicht nach Gesetz oder Gesellschaftsvertrag, durch Beschluß nach Absatz 2 oder als zusätzlicher Aufwand auf Grund des Beschlusses über die Verwendung des Ergebnisses von der Verteilung unter die Gesellschafter ausgeschlossen ist."* English translation:

	"The shareholders shall be entitled to receive the ***annual profit*** *plus carried forward profits minus carried forward losses, to the extent such amount is not excluded from distribution to shareholders by law, the articles, a resolution pursuant to (2) or because such profit constitutes an additional expense pursuant to the resolution on the appropriation of profits."*
Test	Profits test
History of the provision and legislation	No substantive changes to the profits test have been made since 1897
Criticisms	There continues to be strong support in German academia for the maintenance of capital doctrine – the test is seen as an indispensable component. The main criticism / push for reform come from the debate at the European Union level about changes to the maintenance of capital regime. There is strong ongoing debate between the United Kingdom and continental Europe.
Distribution or dividend?	Dividend is effectively defined by way of the prohibition of all unauthorised payments to shareholders
Out of profits?	Only out of profits
Relationship with accounting standards	The accounting standards applicable to Aktiengesellschaft and GmbH are set out in statute (Handelsgesetzbuch – HGB)
Positive or negative language?	Positive language – there is an obligation to distribute profits to the extent they are not excluded from distribution

4. Canada

Legislation	*Canada Business Corporations Act*, RSC 1985, c. C-44, section 42
Actual section wording (emphasis added)	Section 42: *"A corporation shall* ***not declare or pay a dividend*** *if there are reasonable grounds for believing that* *(a) the corporation is, or would* ***after the payment be, unable to pay its liabilities as they become due****; or* *(b) the* ***realizable value*** *of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes."*
Test	Dual solvency and balance sheet test.
History of the	Emulates the two-pronged solvency test in section 6.40(d) of United States Model

provision and legislation	Business Corporation Act, the basis for Canada Business Corporations Act's reform. The Dickerson Report's, draft legislation and commentary, was adopted virtually unchanged as the Canada Business Corporations Act. Previously, the Corporation Act had not been overhauled since 1934.
Criticisms	
Distribution or dividend?	Dividend
Out of profits?	No prohibition – would allow distribution otherwise than out of profits if dual solvency test satisfied.
Relationship with accounting standards	
Positive or negative language?	Negative language

5. United States of America

Delaware

Legislation	*General Corporation Law*, 8 Del. C., §170 (1953)
Actual section wording (emphasis added)	§170(a); *"The directors of every corporation, subject to any restrictions contained in its certificate of incorporation,* ***may declare and pay*** *dividends upon the shares of its capital stock either:* *(1)* ***Out of its surplus****, as defined in and computed in accordance with §§ 154 and 244 of this title; or* *(2) In case there shall be no such surplus, out of its* ***net profits*** *for the fiscal year in which the dividend is declared and/or the preceding fiscal year."*
Test	Profits test.
History of the provision and legislation	Introduced by 8 Del. C. 1953. No significant amendments have been made to §170 since that time.
Criticisms	
Distribution or	Dividend

dividend?	
Out of profits?	Prohibitive – Only out of surplus/net profits. Corporations cannot declare dividends except out of profits.[6] Capital cannot be impaired by payment of dividend. Such income or return to stockholders can only be legally be paid from current or accumulated profits.[7] But, §170 has the so-called "nimble dividend" provision, allowing dividends to be paid out of profits from the current or preceding year. Also, §160 permits shares to be repurchased or redeemed out of surplus.
Relationship with accounting standards	Directors must be given reasonable latitude in ascertaining values (for purposes of revaluing assets in order to pay dividends), and that absent a showing of fraud or bad faith, [the court] would not substitute its judgment for that of the directors.[8]
Positive or negative language?	**Positive and negative language** Stipulates that dividend not invalid if it could have been lawfully paid at the time.

Model Business Corporation Act

Legislation	*Model Business Corporation Act,* §6.40 The Model Business Corporation Act has been adopted by approximately 32 states in the United States of America.[9]
Actual section wording (emphasis added)	§6.40(a) and (b): *"(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection (c).* *(b) No distribution may be made if, **after giving it effect:*** *(1) the corporation **would not be able to pay its debts as they become due** in the usual course of business; or* *(2) the corporation's **total assets would be less than the sum of its total liabilities** plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution."*

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[6] *Penington v Commonwealth Hotel Construction Corp.*, 17 Del. Ch 394, 155 A.514 (1931).

[7] Ibid

[8] *Morris v Standard Gas & Electric Co.*, 31 Del. Ch 20, 63 A.2d 577 (1949).

[9] American Bar Association, *Business Law Section: Corporate Laws* (13 July 2012) <http://apps.americanbar.org/dch/committee.cfm?com=CL270000>.

Test	Dual solvency and balance sheet test, sometimes called the equity insolvency test.
History of the provision and legislation	The Model Business Corporation Act was produced by the American Bar Association. In 1980 the statutory standards governing distribution were revised, removing concepts of "par value" and "stated capital" but retaining the equity insolvency test.
Criticisms	Criticised for pursuing flexibility and modernization too aggressively, at the expense of shareholder protection. Directors have been given much more latitude in declaration of dividends – the overall judgment required in evaluating the equity insolvency test means there is no one or more "bright line" tests. Certain judgments and assumptions as to the course of the business are customarily justified.
Distribution or dividend?	**Distribution** §1.40(6) defines "distribution" as a direct or indirect transfer of money or other property (except own shares) or incurrence of indebtedness by a corporation to or for benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares, a distribution of indebtedness or otherwise. Thus, it includes a declaration or payment of dividends and **unlike the United Kingdom and Hong Kong** – purchase of corporation's own shares, distribution of evidences of indebtedness or promissory notes, and distribution in in/voluntary liquidation.
Out of profits?	Would appear to allow distribution otherwise that out of profits.
Relationship with accounting standards	§6.40(d) (emphasis added): *"The board of directors* ***may*** *base a determination that a distribution is not prohibited under subsection (c) either on* ***financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances*** *or on a fair valuations or* ***other method that is reasonable in the circumstances.****"* Does not utilise particular accounting terminology of a technical nature or specify particular accounting concepts, unlike the United Kingdom, Hong Kong and Delaware, and directors are given a choice of permissible bases upon which to judge the balance sheet test. The use of generally accepted accounting principles is not mandated as it is in section 254T(2) of the *Corporations Act 2001* (Cth), New Zealand, the United Kingdom and Hong Kong. Allowing the use of current value methods to determine amounts available for distribution aims to ensure the most appropriate methods are used for a particular corporation and its circumstances.
Positive or negative	Negative language

language?	

6. Hong Kong

Legislation	*Companies Ordinance* (Hong Kong) cap 32, Part IIA section 79B, Sch 1, section 117
Actual section wording (emphasis added)	Part IIA, section 79B(1) and (2): "*(1) A company shall not make a distribution except out of profits available for the purpose.* *(2) For the purposes of this Part, a company's profits available for distribution are its accumulated,* ***realised profits****, so far as not previously utilised by distribution or capitalisation, less its* ***accumulated****, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.*"
Test	Profits test – prohibits distribution except out of profits available for the purpose – same as section 830 of the *Companies Act 2006* (UK). The test is based on the distribution pool available for paying a dividend, rather than on setting preconditions as to when a dividend can be paid.
History of the provision and legislation	Part IIA, sections 79A and 79B copy the *Companies Act 1985* (UK). The 1997 Review of the Hong Kong Companies Ordinances Consultancy Report recommended adopting the two-pronged solvency test found in §6.40(d) of the United States Model Business Corporation Act and emulated in New Zealand but this was not taken up.
Criticisms	Capital maintenance and dividend rules, upon which the Ordinance is based, is extremely detailed and complex. Affords little protection to private companies and nor to creditors.
Distribution or dividend?	**Distribution** Has the same wide definitions as the *Companies Act 2006* (UK) with the same exclusions for certain reductions of capital, bonus shares, redemption/purchase of own shares. But section 117 also specifies "*no dividend shall be paid...*" – the Ordinance explicitly covers both.
Out of profits?	Prohibitive – only out of profits. Profits now defined in section 79B(2) – same as the *Companies Act 2006* (UK).
Relationship with accounting standards	Adopts *Companies Act 2006* (UK) method of treating realised profits in accordance with **principles generally accepted at the time accounts are prepared.**

Positive or negative language?	**Negative language** A distribution in breach of the provision is unlawful and ultra vires (annotated ordinances).

7. China

Legislation	The Company Law of the People's Republic of China (People's Republic of China) National People's Congress, 27 October 2005, sections 35 and 167 (**2005 Company Law**)
Actual section wording	Section 35: *"The shareholders shall be distributed with the dividends in proportion to the percentages of their contribution in the paid-up capital. When a company increases the capital, its shareholders have the pre-emptive right to subscribe to the increased capital in proportion to their contribution in the paid-up capital. The exception to the above is that the shareholders may agree that they will not be distributed with the dividends or have the pre-emptive right to subscribe to the increased capital in proportion to the percentages of their contribution in the paid-up capital."* Section 167: *"Where a company distributes its after-tax profits of the current year, it shall draw 10 percent of the profits as the company's statutory common reserve. The company may stop drawing from the profits as statutory common reserve if the aggregate balance of the statutory common reserve has already accounted for over 50 percent of the company's registered capital.* *If the aggregate balance of the company's statutory common reserve is not sufficient to make up for the losses of the company of the previous year, the current year's profits shall first be used for making up for the losses before the statutory common reserve is drawn according to the provisions of the preceding paragraph.* *After the company has drawn statutory common reserve from the after-tax profits, it may, upon a resolution of shareholders' meeting or shareholders' assembly, draw a discretionary common reserve from the after-tax profits. After the losses have been made up and common reserves have been drawn, the remaining profits shall be distributed to shareholders according to Section 35 of this Law in the case of a limited liability company, or based on the shareholding percentage of the shareholders as in the case of a joint stock company unless otherwise stipulated in the articles of association of the joint stock company* *If the shareholders' meeting, shareholders' assembly or board of directors distributes the profits in violation of the provisions of the preceding paragraphs before the losses are made up and the statutory common reserves are drawn, the profits distributed must be refunded to the company. No profit may be distributed for the company's shares held by*

	itself."
Test	Profit test – no profit can be distributed before paying taxes, making up for losses, as well as drawing certain amount as statutory common reserve, and discretionary common reserve as determined by shareholders' meeting.
History of the provision and legislation	Introduced as sections 33 and 177 of The Company Law of the People's Republic of China (People's Republic of China) National People's Congress, 29 December 1993 (**1993 Company Law**). The 1993 Company Law did not clearly provide whether dividends could be distributed to shareholders based on the percentage of subscribed capital or paid-up capital. The 2005 Company Law modified the 1993 Company Law by providing dividend distribution based on percentage of paid-up capital, and also permitting the shareholders, by unanimous agreement (in the case of a limited liability company) or the shareholders through the articles of association (in the case of a joint stock company), to opt out the statutory basis of dividend distribution.
Criticisms	Lack of clarity on definition of distribution, and whether share redemption and capital reduction should be subject to the same restrictions as dividend distribution. The narrow concept of distribution under the legislation may not afford creditors and minority shareholders sufficient protection.
Distribution or dividend?	**Dividend** Share redemption, capital reduction, liquidation distribution are excluded as a form of distribution from this legislation, which has a narrower scope than the United States Model Business Corporation Act or *Companies Ordinance* (Hong Kong).
Out of profits?	Prohibitive – only out of profits
Relationship with accounting standards	Test requires assessing the distributable profits in accordance with applicable accounting standards. The same legal entity may have different distributable profits if assessed as different accounting entity, for instance, being assessed as a controlling entity which consolidates the financial statements of its subsidiary.
Positive or negative language?	Positive language

8. Cayman Islands

Legislation	*Companies Law (2011 Revision)* (Cayman Islands)
Overview	A Cayman Islands company may declare and pay a dividend on its shares out of either profit or share premium account. Subscription monies reflecting pure share capital (ie. the par value on issued shares) may not be used for the payment of dividends.

	Often Cayman Island companies are structured so that only a small proportion of share subscription moneys comprise share capital with the balance being share premium. This allows dividend flexibility.
Actual section wording	Section 34: *"(1) Where a company issues shares at a premium … a sum equal to the aggregate amount of the value of the premiums on those shares shall be transferred to an account called "the share premium account" …* *(2) The share premium account may be applied by the company subject to the provisions, if any, of its memorandum or articles of association in such manner as the company may, from time to time, determine including, but without limitation-* *(a) paying distributions or dividends to members; …* *Provided that no distribution or dividend may be paid to members out of the share premium account unless, immediately following the date on which the distribution or dividend is proposed to be paid, the company shall be able to pay its debts as they fall due in the ordinary course of business; and the company and any director or manager thereof who knowingly and wilfully authorises or permits any distribution or dividend to be paid in contravention of the foregoing provision commits an offence and is liable on summary conviction to a fine of fifteen thousand dollars and to imprisonment for five years."*
Test	The test is whether both: • the sum of the company's retained profits and the balance of the company's share premium account are sufficient to cover the proposed dividend; and • the company is able to pay its debts as they fall due in the ordinary course of business. This is to be assessed immediately following the date on which the distribution or dividend may be paid.
History of the provision and legislation	The *Companies Law (2011 Revision) (Cayman Islands)* is largely derived from the older Companies Acts of the United Kingdom, in particular the *Companies Act 1948* (UK).
Criticisms	
Distribution or dividend?	Distribution or dividend
Out of profits?	See the test described above.
Relationship with accounting standards	None
Positive or	Negative language

negative language?	

9. South Africa

Legislation	*Companies Act 71 of 2008* (South Africa)
Actual section wording	Section 46(1): *"A company must not make any proposed distribution unless—* *(a) the distribution—* *(i) is pursuant to an existing legal obligation of the company, or a court order; or* *(ii) the board of the company, by resolution, has authorised the distribution;* *(b) it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and* *(c) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution."* Section 4(1): *"For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—* *(a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and* *(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—* *(i) 12 months after the date on which the test is considered; or* *(ii) in the case of a distribution contemplated in paragraph (a) of the definition of "distribution" in section 1, 12 months following that distribution."*
Test	United States-style solvency (assets exceed liabilities, balance sheet) and liquidity (able to pay its debts as they fall due, cash flow statement)
History of the provision and legislation	Solvency and liquidity requirements for distributions to shareholders were first introduced for payments of dividends and distributions, in 1999. The new section replaced the profit test that had applied to dividends until then. The new Companies Act was adopted in 2008 and become effective in 2011. This did not change the solvency and liquidity test but it did clarify its application.

Criticisms	At this relatively early stage, this has been relatively well-received as an improvement to certain uncertainties in the application of the old solvency and liquidity test.
Distribution or dividend?	Distribution replaced dividends in 1999
Out of profits?	Profits not required. The test is based on the United States-style solvency and liquidity enquiry.
Relationship with accounting standards	The Companies Act provides that a company must consider a fair valuation of the company's assets and liabilities in conjunction with any reasonably foreseeable contingent assets and liabilities and may consider any valuation of the company's assets and liabilities that are reasonable in the circumstances. In addition, the Companies Act allows that the board or other person applying the test "may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances". The Companies Act is also clear that any financial information to be considered concerning the company in making the assessment, must be based on the accounting records and the financial statements under the Companies Act.
Positive or negative language?	Negative language

LCA Business Section

Australia's Dividend Rules

Commentary on paper by Austin and Golding

A H Slater
20 October 2012.

A. Ability to pay dividends

1. Section 254T is not an enabling provision. The section

   (a) imposes a statutory constraint on what the company might otherwise do, as a matter of company law; and

   (b) repeals an earlier statutory constraint on what the company might otherwise do (originally imposed in the 1896 Victorian Act, and taken up as s 376 of the 1961 Acts, s 565 of the 1981 Companies Code, s 201 of the 1989 Corporations Law and moved to s 254T of the Act in 1998): that "a dividend may only be paid out of the profits of the company."

2. The common law principles derived from the nature of the company, and the implied compact made among the legislature, the company and its corporators, are not abrogated by the amendment to s 254T. In this regard I differ somewhat from the view taken in today's paper.

B. What comprises equity accounts of a company

3. Company law differs fundamentally from trust law. The company beneficially owns the assets vested in it. No question of tracing claims on the assets into what they are exchanged for by the trustee, or into the hands of third parties, arises in relation to assets vested in the company. In particular –

(a) the company's capital assets are not its capital, even if they are transferred to it in exchange for shares or purchased with the proceeds of an issue

(b) the state of a company's capital and profits reserves does not depend on how with the assets vested in it are deployed

(c) trust law (like most areas of the law) uses single entry accounting. Company law uses double entry accounting.

4. Before the AASB succumbed to International Financial Reporting Standards and their antecedents in the middle of the last decade, companies were required to produce and distribute to their members a "balance sheet." The important thing about a balance sheet was that it had to balance: that is, the net assets of the company (assets less external liabilities incurred or provided for) had to balance with, viz equal in recorded amount, the company's total capital and profit reserves. The centrality of this idea was lost to sight when the company was required to produce instead a narrative "statement of financial position" (notwithstanding that double entry accounting still required the accounts to balance).

5. When shares had a par value (which the subscribers had to pay on issue or on call), it was easy to see that when the company's net assets exceeded the amount of the paid up capital, the company had – in one way or another – made profits at least equal to the difference. The balance sheet disclosed this clearly and neither accountants nor courts had any difficulty with the concept.

6. So clear was the idea that when the directors were able to secure a premium on the issue of shares (presumptively because the value of the existing shares had increased to the extent of the company's retained profits) the courts had no difficulty in concluding that the premium was a profit which the company had been able to realize, and that the profit was therefore not "capital" of the company and was available for distribution: *Moore v Carreras Ltd* [1935]

VLR 68, *Drown v Gaumont-British Picture Corp Ltd* [1937] Ch 402. The legislature recharacterised the amounts subscribed as capital, first in s 50 of the 1958 Victorian Act and later in s 60 of the 1961 Act. With the abolition of par value of shares (s 254C) the amount of all subscriptions on the issue of shares is credited to share capital account.

7. The significance of the foregoing is that the equity accounts of the company can be divided into two mutually exclusive categories, which must sum to no more and no less than its net assets. The two categories are the subscribed capital (or the balance of it if some has been lost), and profits. The profits may be distributed in dividends (which will only be out of profits – the common law rule). The subscribed capital may not (the common law maintenance of capital rule). The two rules are in reciprocal balance: neither transgresses upon the other. Each remains in operation, subject to the statutory limit now imposed by s 254T. Neither has "primacy" over the other: operating with equal force and conceptual content, they cover the field.

8. There is in today's paper a hint of an implicit premise that the equity and profit accounts may in some circumstances overlap, or that there are some amounts secreted among the equity accounts (and represented by net assets) which are neither capital nor profits. If such a premise does underpin the argument, it is wrong. The amounts referred to in the AASB101 definition of "other comprehensive income" are all profits, whatever label may be attached to them or direction given as to their recording in the standards; as indeed is recognized in (for example) AASB116 at [39-40] and AASB138 at [85-6]. They are all "gains and losses."

9. In some circumstances subscribed capital may be lost. When the balance of net assets falls below subscribed capital, some has clearly been lost. Other circumstances have been accepted as possible: for example, when an existing fund of profits is preserved and the company allocates losses to the capital account. Depletion in value of a capital asset has been treated as a

loss of subscribed capital invested in the asset (*Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1), although the reasoning is an instance of single entry accounting and would not be accepted as satisfying the requirements of s 296. Where subscribed capital has been lost, the balance of net assets over the remaining amount of subscribed capital is profits which, subject to s 254T, are available for dividend.

10. External transactions of the company may result in losses recorded in a profit and loss account; in some circumstances, there may also be a fund (account) of profits kept separate from the loss account. In such cases there may be debit, or negative, balances in the equity accounts.

11. Internal transactions (ie, between the company and its members as such) cannot properly result in a "negative equity" account which may be taken into the sum of equity accounts equaling net assets. Although an accountant may with the authority of the Board made such an entry in the ledger, it is simply a deceit: a deliberate failure properly to record the transaction. The share buy back reserve in *Consolidated Media Holdings* is one such account: whatever was written in the accounts, the transaction was a return of capital. The debit account written up in *Uther v FC of T* (1964) 111 CLR 318 was another: in that case, the only proper accounting entry was a debit partly to subscribed capital (to the extent of the authorized reduction) and partly to the profits reserves of the company. The minority view of Kitto J on appeal (endorsed as "compelling" by the Full Court in *FC of T v Slater Holdings Ltd* (1984) 156 CLR 447, 457) is correct; the majority applied single entry accounting to the position of the shareholder, looking to the tracing of the shares (capital assets in their hands) into the cash received.

C. Reform proposals

12. The essential problem with the present s 254T is that insufficient thought was given to its drafting and its relationship with the other provisions of the Act. It was simply an incompletely considered patch applied to the legislation.

13. The LCA proposal recorded in the paper suffers from the same deficiency. First, it does not properly invoke the notion of solvency in s 95A; a mere note is insufficient (whose solvency, for example?). The concept would appear to be embodied in words something along the lines "A company may pay a dividend on its share capital provided that following payment it is solvent" whereupon the definition in s 95A is imported.

14. But second and more important it fails to address the relationship with the rest of the Act. For example, the criticism of the present s 254T, that it is not meshed with Ch 2J, is equally applicable to the draft.

15. What is needed is a complete reconception and redrafting of Chapters 2H, 2J and at least in part 2M. It should (if this is the policy position adopted) simply state (subject to protective limitations) that shares may be issued at whatever price and with whatever rights the company and the subscriber agree; that they may be cancelled on whatever terms the constitution provides or the member assents to; and that the company may make whatever distributions of assets to members it chooses. The protective limitations would go to such things as solvency, fairness to creditors and members, and representations to investors. There is no need to retain such hangover concepts as reduction of capital, redeemable preference shares or redemption out of profits, share buy-backs or the company's self-acquisition of, financing or dealing in its own shares, however familiar and comfortable they are to long standing practitioners. Nor is there need for provision for partly paid shares: the amount payable, and the consequences of non-payment, are simply a matter of contract, overtly *inter partes* or embodied in the constitution. Clear thought and principles based drafting would reduce two chapters to perhaps 10 pages (shades of the 1961 Act).

16. For my own part, some decades of experience of the "cleverness" which may be brought to company structures by those seeking an advantage over investors or the revenue leads me to prefer some judicial supervision of the games which might otherwise be played with company assets.