

Discussion Paper on Proposed Amendments to the Corporations Act

1 Summary

We set out below our submissions in response to Treasury's Discussion Paper on the Proposed Amendments to the Corporations Act; specifically, in connection with the proposed changes to the dividend provisions in s254T of the Act.

In summary:

- Of all the options suggested in the Discussion Paper to amend the dividend test, we support Option 4 (which enables companies to choose between a “profits test” or “net assets/solvency” test), subject to certain amendments as outlined below:
 - (a) Treasury should specifically clarify that a dividend paid otherwise than out of profits is otherwise authorised by law and will not require shareholder approval under Chapter 2J of the Act.
 - (b) In determining whether a company has sufficient net assets to pay a dividend, we consider that a calculation of net assets in accordance with applicable accounting standards would be unduly restrictive – rather, we support the New Zealand formulation of this test, whereby consideration should also be given to all circumstances which may affect the value of the company's assets and liabilities, including valuations of assets or estimates of liabilities that are reasonable in the circumstances.
 - (c) The net assets test as described above should be met as nearly as practicable before the time relevant dividend is either “declared” or “determined” (rather than either “declared” or “paid”).
- Another alternative to Option 4 (not canvassed by the Discussion Paper but which we consider has merit) is to revert to the previous profits test in s254T **and** amend the equal capital reduction provisions in Chapter 2J of the Act so that a company can effect an equal capital reduction without shareholder approval, provided the company has sufficient net assets for the capital reduction and meets the other requirements in s256B(1)(a) and (b). This would have the same practical effect as Option 4, and is likely to be less confusing for shareholders, particularly from a tax perspective.

2 Reasons for supporting Option 4

2.1 Background to section 254T

Section 254T was amended in June 2010 to replace the requirement that a dividend could only be paid out of profits (the “profits test”) with a provision that permits a company to pay a dividend if:

- (a) its assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;

- (b) it is fair and reasonable to the company's shareholders as a whole; and
- (c) it does not materially prejudice the company's ability to pay its creditors.

(the "net asset test").

2.2 Difficulties associated with s254T and net asset test

Following this amendment, it became apparent to us that a number of our clients have been or would be adversely affected by the changes. In particular, leveraged companies with large amounts of internally generated goodwill which cannot be recognised in their accounts and companies holding assets with low historical book values that do not adopt a fair value accounting methodology have found themselves prohibited from paying dividends as a result of the net asset test, even though these companies have sufficient profits and are robustly solvent.

There are a number of other difficulties caused by the current formulation of s254T which are also referred to in the Discussion Paper and addressed in this submission.

2.3 The profits test should be reintroduced as an alternative

One of the reasons for the 2010 amendments to s254T was that the previous profits test was inconsistent with the trend to lessen the Australian capital maintenance doctrine – indeed, limbs (b) and (c) of the net asset test in paragraph 2.1 above mirror the requirements in the capital reduction provisions of the Act in s256B(1)(a) and (b) respectively. The policy rationale of s254T was to enable companies to pay a dividend even if it did not have sufficient profits at the time of payment, provided the company could meet the net asset requirements.

However, the recent releases by the ATO (including Draft TR2-11/D8 and the associated counsels' opinion) make it clear that for income tax purposes, a "dividend" inherently involves a distribution of profits and s254T has not done away with this meaning. The corollary to this is that a distribution to shareholders which is not made out of profits is in fact a capital reduction, from both an accounting and tax perspective.

Leaving aside the issue of whether or not such a distribution would amount to an unauthorised capital reduction from a corporate law perspective (see further paragraph 3.1 below) the practical effect of s254T is that companies that currently wish to pay a "dividend" (as that word is generally understood by shareholders and companies, i.e. a distribution that is generally assessable as income and frankable) will currently have to comply with the profit test and also the net asset test.

If one assumes that s254T does allow distributions to be made from capital without breaching Chapter 2J of the Act, then the only additional significant benefit of the current s254T as compared to its predecessor provision is that a company does not need shareholder approval for an equal capital reduction, provided the company's assets exceed its liabilities by the amount of that capital reduction (see further our submissions in paragraph 4 below).

For this reason, we are of the view that Option 4 is the best of the alternatives presented in the discussion paper, as it allows companies to choose between a profits test or a net asset test.

3 Suggested amendments to Option 4

We suggest below a number of amendments to Option 4 which we consider would be beneficial. Of these amendments, the amendment proposed in paragraph 3.1 below in relation to the application of Chapter 2J is the most significant.

3.1 Application of Chapter 2J of the Act

We consider that there is sufficient doubt as to whether a distribution other than out of profits of the company under s254T would amount to an unauthorised capital reduction in breach of Chapter 2J of the Act.

We also note the Counsels' opinion released by the ATO which suggests that in Counsels' view a distribution which is effectively a capital return must comply with Chapter 2J (notwithstanding that the distribution meets the requirements of s254T).

We suggest that legislative amendment is required to clarify that a payment of a dividend in compliance with s254T is a circumstance where a capital reduction is "otherwise authorised" by the law for the purposes of Chapter 2J.

Given the consequences of the ambiguity, we expect that companies will continue to adopt a prudent approach of only paying dividends out of profits until this clarification is provided.

3.2 Method of calculating net assets

In determining whether a company has sufficient net assets to pay a dividends, we consider that a calculation of net assets in accordance with applicable accounting standards may, at times, be unduly restrictive – rather, we support the New Zealand formulation of this test, whereby consideration should also be given to all circumstances which may affect the value of the company's assets and liabilities, including valuations of assets or estimates of liabilities that are reasonable in the circumstances.

This would avoid a "dividend trap" (preventing dividends from flowing to shareholders) that may be encountered by companies in Australia which have a large amount of internally generated goodwill or brands, or which have assets with low book values but high fair market values.

We note that this sort of approach has precedent in an Australian context – for example, the calculation of assets for thin capitalisation purposes allows companies to recognise and revalue internally generated goodwill and brands.¹

Further, the amendments suggested above do not compromise the interests of creditors, which will be protected by requirement in s254T that the dividend does not materially prejudice the company's ability to pay its creditors and the overarching obligation on directors in s588G to prevent a company from trading insolvent.

3.3 Timing for calculation of net asset test

The Discussion Paper currently proposes that the calculation of a company's net assets be undertaken "immediately before the time either the dividend is declared or for payment of the dividend".

We welcome the addition of the words "payment of the dividend", which is a departure from the current formulation in s254T and recognises the fact that many boards "determine" rather than "declare" dividends.

However, we are of the view that a better formulation would be if the net assets test is met before the time either the relevant dividend is "declared" **or** "determined".

¹ Sections 820-680 to 820-684 of the *Income Tax Assessment Act 1997*.

The reality is that many companies “determine” rather than “declare” dividends, given the legal implications of “declaring” a dividend (which gives rise to a debt). If the net asset calculation has to be undertaken immediately prior to payment of a dividend, companies will effectively have to run the calculations twice – once when the dividend is determined and again just prior to payment of the dividend.

This would increase the burden of compliance on companies, particularly if Treasury ultimately determines that the net asset test has to be undertaken by reference to applicable accounting standards (rather than a less rigid reasonable or realisable value formulation).

There has also been some concern over the requirement that the net asset calculation be undertaken “immediately” before the declaration of the relevant dividend. The preparation of accounts is not an event that can be undertaken in “real time” – as a generalisation, most accounts prepared to an audit level standard take between 45 – 60 days to prepare.

This lag is another pillar in the argument against calculating the net asset test by reference to accounting standards - a less restrictive test based on realisable or reasonable value would enable companies to perform a net asset calculation within a realistic time frame that is considerably more proximate in time to the declaration or determination of the dividend.

For this reason, we would support a formulation of s254T where the net asset test is calculated “as nearly as practicable” before the time when the relevant dividend is either declared or determined.

4 Alternative to Option 4 – amendment of the equal capital reduction provisions

We support another alternative to Option 4 which has not been canvassed by the Discussion Paper but which has the same practical effect as Option 4, with some additional benefits.

The proposed alternative is to revert to the previous profits test in s254T for the payment of dividends while simultaneously amending the equal capital reduction provisions in Chapter 2J of the Act. The amendments would allow a company to undertake an equal capital reduction without having to obtain shareholder approval, if:

- (a) The company’s assets exceed its liabilities immediately before the dividend is declared or determined and the excess is sufficient for the consideration to be provided under the capital reduction;
- (b) The reduction is fair and reasonable to the company’s shareholders as a whole; and
- (c) The reduction does not materially prejudice the company’s ability to pay its creditors.

This would have the same practical effect as Option 4 in that companies that meet the profits test can continue to pay dividends as they have done in the past (and such dividends would be generally assessable as income and frankable). Companies that do not have sufficient profits will also be able to make distributions to shareholders through a return of capital, provided that those companies are able to meet the “net asset” test.

This is likely to be less confusing for shareholders, as they will be able to clearly identify which distributions have the nature of a “dividend” (in the sense that they are assessable and frankable) and which distributions are effectively returns of capital.

As against this we recognise that, unlike Option 4, this alternative does not allow companies the flexibility to call a distribution which is effectively a capital return a “dividend”, which some companies may wish to do in certain circumstances (for example, to signal an intention to continue paying dividends).

5 Contacts

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