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The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
Australian Treasury
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Response to Treasury Discussion Paper "Proposed Amendments to the Corporations Act"

Dear Sir / Madam

Ernst & Young is pleased to submit its comments on the proposals set out in the Treasury Discussion Paper "Proposed Amendments to the Corporations Act" of November 2011 ("the paper").

We agree that certain provisions introduced in the Corporations Amendment (Corporate Reporting Reform) Act 2010 ("the 2010 amendments") require reform.

Of the four proposed dividend test options in the paper, our preference is for an approach similar to the test already adopted in New Zealand (Option 2). However, we believe additional changes are needed for the proposed amendments to be effective in the Australian environment.

We urge the government to clarify the difference between a dividend and a return of capital. Currently, and even after the proposed changes, the two concepts overlap, resulting in significant uncertainty and differences of opinion, as to whether a payment is a dividend or a return of capital. Consequently, there is uncertainty as to which requirements under the Corporations Act must be followed, and further uncertainty as to the taxation treatment.

We also urge the government to amend what appear to be unintended consequences of the parent entity exemption in consolidated financial statements, to ensure that unlisted entities preparing consolidated special purpose financial reports also achieve the benefit of the exemption.

Dividend franking issues need specific amending tax legislation

The paper noted concern about the dividend franking issues, in particular whether dividends paid under Section 254T as amended could be franked. Since the paper was released, a draft Australian Tax Office (ATO) ruling and lengthy joint legal opinion by senior counsel Messrs Slater QC and Hmelnitsky, released on 23 December 2011, state that, despite recent Government amendments to improve the capacity of companies to pay dividends, these dividends will not be franked in many cases.

The ATO position means that, despite the government's 2010 amendments expressly to "cut down on the red tape and regulatory burden relating to" companies and dividends, the dividends may often not be able to be franked.

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The ATO materials are based on an integrity provision in the dividend imputation tax law to justify the position. In our view that integrity provision needs to be adjusted so as to align to the clear policy intent to restore companies' capacity to pay dividends which includes, in our view, the requirement for those dividends to be capable of being franked if that company has paid tax.

It is clear to us that urgent attention is needed to adjust the law to resolve the franking issue and a proposal is contained in section 2.4 of Appendix 1.

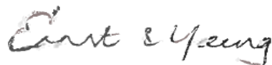
Our responses to all of the questions in the proposals are in Appendix 1 to this letter.

Because of the significance of the tax issues which need to be rectified, we are copying in Assistant Treasurer Senator Mark Arbib and his tax adviser Mr Glen McCrea, and also Mr Tony Regan of Treasury who we understand is responsible for dividend imputation tax policy issues.

Should you wish to discuss the contents of this letter with us, please contact David Hardidge – Executive Director, Financial Accounting Advisory Services on (07) 3807 1975 or david.hardidge@au.ey.com or Lynda Tomkins – Partner, Australian IFRS Leader on (02) 9276 9605 or lynda.tomkins@au.ey.com

Concerning the dividend imputation/franking issues, please contact Simon Jenner, Partner – Tax services on (02) , 02 8295 6367 or Tony Stolarek – Partner, Tax Centre for Excellence & Tax Policy Services on (03) 8650 7654, tony.stolarek@au.ey.com

Yours faithfully



Ernst & Young

cc. Mr Mark Arbib - Senator.arbib@aph.gov.au
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APPENDIX 1
DETAILED RESPONSES TO IN THE TREASURY DISCUSSION PAPER

2.1 Test for payment of dividends

Issues for consideration

Stakeholders are invited to provide their views about each of the four options listed in this paper (including an indication of their preferred option or options).

Are there other options for dealing with the dividends test that could be considered by Treasury?

We note below our specific comments on each option. Regardless of this, we believe the government should clarify the difference between a dividend and a return of capital, for corporations law and for dividend imputation purposes, to implement the policy intent to "cut down on the red tape and regulatory burden relating to[1]" dividends.

The extensive legal opinion (by Slater and Hmelnitsky) issued by the Australian Taxation Office (ATO) with its Draft Taxation Ruling TR 2011/D8 on taxation of dividends, referred to dividends continuing to be being based on the "profits test". The opinion indicates that the 2010 Corporation Act changes, and any of the proposed changes, will be ineffective for dividend imputation and for corporations law purposes if a distribution is not made "from profits". As noted below, we believe that a "profits test", either explicitly in legislation (such as the Corporations Act or Income Tax Assessment Act), or implicitly in case law not otherwise overridden by legislation, is no longer appropriate.

As mentioned above, we also urge the government to clarify the taxation treatment of dividends due to the substantially different outcomes depending on whether a distribution is regarded as a dividend (from profits) or a return of capital.

Not only does the current uncertainty mean that directors may not be able to determine which requirements to follow, and consequently may inadvertently breach the Corporations Act, even though they think they are merely paying a dividend, but shareholders may be adversely affected by later reclassifications of dividends as returns of capital for tax purposes or vice versa.

The ability of companies, especially listed and widely held companies, to pay dividends affects their financial attractiveness to investors, their financial strength and ability to grow employment. That is why the Labor Government introduced the 2010 amendments, to allow companies more easily to pay dividends where the companies were solvent, to cut down on the red tape and regulatory burden of Australian companies[2]. These changes followed input from the corporate sector and the Australian accounting bodies to allow companies more easily to pay dividends, because changed accounting standards impair the ability of companies to pay dividends in many cases because they restrict companies' reported profits. In our view, as stated in response to the Bill when it was issued in draft form, it is necessary for those dividends to be capable of being franked if that company has paid tax.

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[1] The Hon David Bradbury MP, Media Release of 28/11/2011, No.057 "Discussion Paper on Reform to Dividends Payment Test"

[2] The Hon David Bradbury MP, Media Release of 28/11/2011, No.057 "Discussion Paper on Reform to Dividends Payment Test"

We comment on the various proposals as follows.

Retaining the Current legislation – Option 1

We do not support retention of the current legislation without further amendments.

We do not believe that a test that locks the payment of dividends and their franking credits in to the production of financial statements based on accounting standards, when over 98%[3] of companies do not prepare statutory financial statements, is practical or appropriate.

The 2010 amendments were driven in part by global and Australian accounting standards that require companies to recognise impairment losses on their assets in the event of uncertainty about the value of those assets, but also limit the ability of companies to reverse those losses on various assets. The conservative bias of the accounting standards means that companies which might be completely viable and successful might record little or no profits in their financial statements for a particular year. The rationale for the 2010 amendments was to protect companies' ability to pay dividends, notwithstanding the accounting volatility. Thus, entrenching the use of accounting standards in this context is inconsistent with the policy driver of the amendments.

Using a Solvency test instead of using financial reports – Options 2 and 4

We support the use of a solvency test similar to the New Zealand test (including proposed changes to take into account changes to their financial reporting requirements) that make reference to:

- The use of financial statements when prepared, or other financial records; and
- The use of valuations if desired.

We understand that there have been no significant practical problems in New Zealand with the test.

We understand that the key requirements of the New Zealand test are:

Companies act 1993
4 Meaning of solvency test
(1) 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.

In determining whether paragraph (b) of the above test is satisfied, directors may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances (section 4(2)(b)).

Further, in determining, the value of a contingent liability, directors may consider the likelihood of the contingency occurring; and any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability (section 4(4)).

In addition, we note that, at present, most companies in New Zealand prepare financial statements and most are accounting standards compliant.

[3] At 30 June 1997, 32,814 companies, registered schemes and disclosing entities (out of 1,574,339) (less than 2.1%) were expected to have a reporting obligation. Source: "Corporations Act Entities with Financial Reporting Obligations", http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Corporations_Act_entities_with_financial_reporting_obligations_1.pdf/$file/Corporations_Act_entities_with_financial_reporting_obligations_1.pdf.

However, there are proposals to change the New Zealand Financial Reporting Act to exempt most small & medium-sized companies from preparing general purpose financial reports, and instead prepare special purpose financial statements, using minimum standards set by Inland Revenue. The solvency test is proposed to be changed to reflect the changed reporting requirements where many companies will not be preparing accounting standard compliant financial statements.

We believe this would be a relevant concept to be applied in Australia.

A tax precedent for moving away from financial reports

Moving away from the strict use of calculations based on financial statements is not without precedent. For example, in the area of income tax, the thin capitalisation measures were amended to move away from calculations based on financial statements because of changed financial accounting standards by the Tax Laws Amendment (2008 Measures No. 5) Act 2008, introduced into Parliament by the Labor government on 25 September 2008 ("the 2008 Act"). This change dealt with some of the problems arising from accounting standards which apply in relation to the profits test.

Before the 2008 Act, taxpayers' thin capitalisation calculations had been based principally on the values of assets and liabilities in financial statements.

It was identified that companies and other taxpayers would have difficulties with the thin capitalisation rules, as the IFRS accounting standards could result in a significant understatement of asset values. As a result the tax law would deny taxpayers deductions for certain financing costs where a maximum allowable debt amount was less than their adjusted average debt.

As the Second Reading Speech by Mr Chris Bowen, the then Minister for Competition Policy and Consumer Affairs, and Assistant Treasurer) stated:

> "Schedule 2 modifies the thin capitalisation regime contained in division 820 of the Income Tax Assessment Act 1997 in relation to the use of accounting standards for identifying and valuing an entity's assets, liabilities and equity capital.
>
> The amendments aim to adjust for certain impacts of the 2005 adoption of the Australian equivalents to the International Financial Reporting Standards on entities' thin capitalisation positions. The amendments achieve this by providing for the accounting standard treatment of specified assets and liabilities to be disregarded in certain circumstances.
>
> These amendments require certain entities to exclude deferred tax assets and liabilities, as well as assets and liabilities arising from defined benefit schemes, in undertaking their thin capitalisation calculations. They also enable certain entities, in specified circumstances, to choose to recognise and/or revalue intangible assets-contrary to the relevant accounting standards-for thin capitalisation purposes.
>
> The thin capitalisation regime is a key tax integrity measure, which needs to be able to perform the role it is set. However, given the impact this regime may have on a firm's financing and investment decisions, it is important that the regime operates from a sound base.
>
> These amendments seek to ensure that an appropriate economic value can be recognised for certain assets, and to remove undesirable volatility from year-to-year thin capitalisation calculations, which may introduce uncertainty into future investment planning activity."

The 2008 Act modified the use of accounting values in thin capitalisation calculations broadly to allow entities to:

a) recognise certain internally generated intangible assets that cannot be recognised under accounting standard AASB 138 "Intangible Assets";
b) revalue intangible assets, where this is prohibited under AASB 138 due to the absence of an active market; and
c) exclude from net asset calculations deferred tax assets (DTAs) and deferred tax liabilities (DTLs) that arise as a consequence of accounting standard AASB 112 "Income Taxes" and defined benefit plan assets and liabilities that would otherwise be recognised as a consequence of accounting standard AASB 119 "Employee Benefits".

The capacity for directors to rely on reasonable valuations, as proposed in the solvency test, is an important element to align the test with the true value of a company, which can no longer be guaranteed using financial reports using accounting standards.

Profits test – Options 3 and 4

We believe that a "profits test" is no longer appropriate. Our reasons, which we expand upon in Appendix 2, include the following:

- The changes in accounting standards when moving to IFRS created significant restrictions for companies to record an accretion in value because of the effective inability to revalue identifiable intangible assets or unidentified intangible assets.

- The significant changes to international and Australian Accounting Standards in recent years have included increased use of fair value accounting (resulting in volatility in profits), and the increased use of reserves. It is not clear how these accounting changes affect the amount of profits available for dividends under the "profits test".

- There are difficulties with determining the applicable case law and applying that case law to particular facts and circumstances.

- Profit can no longer be used as a proxy of the accretion of value in a company.

- Many companies (over 98%) are not required to prepare statutory financial statements in accordance with Australian Accounting Standards. Such companies are unlikely to be able to determine what "profits" are without expert assistance.

Choice of profits test or solvency test – Option 4

We do not support the reinstatement of the "profits test", nor do we support the use of a choice between tests.

We outline above our support of a solvency based test similar to the New Zealand test.

2.2 Other Corporations Act issues in respect of the dividends test

Use of 'declared'

Issue for consideration

Stakeholders' views are sought on whether the terminology used in section 254T should continue to use 'declared' or be brought into line with that used in section 254U.

We support clarifying the terminology of "declared" and "determined" as appropriate.

Capital maintenance requirements

Issue for consideration

> *Stakeholders' comments are invited on whether a legislative amendment is needed to clarify that satisfying the test for paying a dividend in section 254T of the Act is a circumstance where a reduction in capital is 'otherwise authorised' by the law.*

We support clarification of the law to ensure that dividends do not also have to comply with other capital return requirements of the Corporations Act.

We believe that it is appropriate to have different approval requirements for dividends and for capital returns. Specifically, we note that some companies have different classes of shares and that having to follow other capital return requirements (like shareholder approval) may inadvertently allow the override of existing rights of the different classes of shareholders. Therefore, a distinction in the applicable approval processes under the Corporations Act, between dividends and a return of capital, will continue to be required.

Application of test to group companies

Issue for consideration

Stakeholders' comments are sought on whether a modification is needed to the manner in which the dividends test applies to group companies to address the situation where an intermediate holding company cannot satisfy the net assets test and, potentially, stops dividends flowing to the parent company.

We believe that the use of a net assets test similar to New Zealand, would assist group entities, by allowing the use of valuations rather than being restricted to amounts determined under accounting standards.

However, we believe that wholly-owned subsidiaries should have particular provisions recognising their special nature. In these situations, reference should be made to the group financial position. We note that for wholly-owned entities that gain relief from lodging financial statements under the ASIC Class Order 98/1418 "Wholly-owned entities" (and associated Deed of Cross Guarantee), the only financial statements available to lenders are those of the consolidated "Closed Group" or the ultimate parent.

2.3 Taxation (franking) issues and directions for reform

As noted above, we believe that a "profits test" either explicitly in the Income Tax Assessment Act, or implicitly in case law not otherwise overridden by legislation, is no longer appropriate.

The policy rationale for the 2010 amendments was to enable companies, whose profits are impaired or eliminated due to accounting adjustments, to nonetheless have the capacity to pay dividends. It is inherent in that policy that the companies' dividends must be able to be franked.

The ATO draft ruling TR2011/D8 "Section 254T of the Corporations Act and the assessment and franking of dividends paid from 28 June 2010" with attached joint opinion from Slater and Hmelnitsky provides in essence that

- the better view is that dividends under the 2010 amendments must still be paid from profits; and
- a 'frankable distribution' means a distribution under section 202 -40 of the Income Tax Assessment Act (ITAA) 1997 that is not an unfrankable distribution under section 202 -45 of the ITAA 1997, amongst other requirements and in particular, a distribution that is not sourced, directly or indirectly, from a company's share capital account (section 202-45(e)).

As a result:

a) a dividend paid in accordance with a company's constitution, without breaching section 254T or Part 2J.1 of the Corporations Act, **that is paid out of current trading profits recognised in its accounts and available for distribution** can be franked. It is not prevented by paragraph 202-45(e) of the ITAA 1997 from being franked merely because the company has unrecouped prior year accounting losses or has lost part of its share capital.[4]

b) for a similar dividend **but paid out of an unrealised capital profit of a permanent character** recognised in its accounts and available for distribution, the franking is available under 202-45(e) only if the company's net assets exceed its share capital by at least the amount of the dividend. This puts the focus on the company's net assets in its financial reports (to create the relevant excess of net assets.[5]

c) A distribution (even if it is labelled as a dividend) that does not comply with section 254T or Part 2J.1 is an unauthorised reduction and return of share capital that will be taxed under the capital gains tax provisions or will be taxed as an assessable unfranked dividend, depending on the particular facts and circumstances of the payment.[6]

[4] Para 3 of the draft ruling and related discussion
[5] Para. 4 of the draft ruling and related discussion
[6] Para 5 of the draft ruling and related discussion.

The above clearly indicates that under the ATO draft view, a dividend that is declared in accordance with section 254T of the Corporations Act may, for taxation purposes, be regarded either as a dividend (from profits) or a return of capital, giving rise to substantially different outcomes for shareholders. In our view, this is inconsistent with the desired government policy and inconsistent with the needs of the corporate sector.

We strongly urge the government to align the franking treatment of dividends with the 2010 amendments – that is, there should be no difference between dividends from revenue profits and capital profits (paras. (a) and (b) above). The reason for our strong view is that:

a) the problems with the "profits test" that mean that directors are often not able to determine their responsibilities, or the taxation outcomes, with reasonable certainty. This submission, particularly Appendix 2, outlines the issues.

b) The problem identified by the ATO in relation to the requirement of section 202-45 of ITAA 1997 in relation to dividends from capital profits is inconsistent with the policy driving the 2010 amendments. Under the ATO draft view, a company may have franking credits from tax already paid, but may be prevented from distributing those franking credits to shareholders, even though there has been an accretion in value of the company, unless the accretion in value is reflected in the financial statements of the company. However, in various circumstances a company will be prevented from recognising unrealised gains in respect of certain assets, for example the revaluation of intangible assets.

That ATO draft view highlights the gap in the 2010 amendments, and the requirement to amend section 202-45(e) of ITAA 1997. We note that we raised this issue in our submission in relation to the Bill which outlined the 2010 amendments.

Recommendation

We submit that if the company is permitted to pay a dividend under the Corporations Act, then it should be able to choose to pass its available franking credits to shareholders, without any limitations of an additional "profits test".

This outcome may be achieved by a simple amendment to section 202-45(e). Currently, this provision states that distributions sourced, directly **or indirectly**, from a company's share capital account are unfrankable distributions. This section could be amended to provide that distributions which satisfy the requirements of section 254T of the Corporations Act are **not** to be taken as being sourced directly or indirectly from share capital account.

We submit that the above amendment might be effective in addressing the tax difficulty that has been highlighted by the ATO draft view, and importantly, would align the taxation outcomes with the policy intent of the 2010 amendments and provide certainty of outcomes to the business community. Specifically, a company that is permitted to pay a dividend under the Corporations Act would not only be able to pass on the benefit of its value accretion to shareholders, but also the benefit of any available franking credits.

We prefer this approach to alternatives such as amending section 202-45(e) to mirror the definition of "dividend" in section 6(1) of the ITAA 1936.

3. Other amendments

3.1 Parent entity reporting requirements

Issues for consideration

Stakeholders' are invited to comment on:

whether an amendment which allows companies, registered schemes and disclosing entities that are required to present consolidated financial statements to also include parent entity financial statements as part of their financial report under Chapter 2M of the Act would adequately address their concerns about parent entity financial reporting?

- *Under such an amendment, the preparation of parent entity financial statements would be optional for all entities that are required to present consolidated financial statements. Should any restrictions be placed on the circumstances in which an entity may decide to prepare parent entity financial statements?*

whether there are other parent entity financial statement-related issues that they consider should be brought to the Treasury's attention?

We believe that the significant issue in relation to this area is to ensure that all companies preparing consolidated financial statements can take advantage of the parent entity relief.

The issue is that the actual amendments only gave exemption if the company was "required by accounting standards" to prepare consolidated financial statements.

While there are different interpretations about how this statement is applied, a significant number believe that companies preparing Special Purpose Financial Reports (SPFR) (e.g. unlisted companies) are technically not "required" to prepare consolidated financial statements - so therefore they are not eligible for the exemption from preparing parent entity accounts.

So in practice, companies preparing General Purpose Financial Reports (GPFR) (e.g. listed companies) obtain the exemption (unless, say, a regulator requires that parent entity information must be included).

We did not identify anywhere in the Explanatory Memorandum or Regulatory Impact Statement of those changes, an intention to have a greater financial reporting burden on unlisted entities than listed entities.

We understand from the Explanatory Memorandum that the purpose of the revisions was that as the parent entity financial statements did not serve a useful purpose, they were not needed to be included where the consolidated financial statements were produced. Instead additional financial information could be included in the notes.

We acknowledge a need for some sort of framework for consolidated financial statements for SPFR, where the accounting standard would not ordinarily be mandatory. We refer to ASIC Class Order 98/1418 that includes requirements for the preparation of consolidated financial statements for entities that are not reporting entities (e.g. those preparing SPFR).

As for the specific proposed change, we support permitting companies to continue to include parent entity information should they choose, or are required, to do so. However, we believe that the ASIC Class Order is sufficient and legislative change is not required. We are concerned that any legislative change will introduce further unintended consequences and note the flexibility given to ASIC for the issue and amendment of Class Orders.

3.2 Changing the financial year of a company

Issue for consideration

Stakeholders' are invited to comment on whether there are other issues associated with the requirements for changing the financial year of a company that they consider should be brought to the Treasury's attention?

We support resolving the unintended consequence of companies being prevented from changing their financial year to a shorter period if they have also used the + / - 7 days provisions.

We also note that there may be other situations where companies have taken advantage of a financial year other than 12 months under other parts of the section that also need similar relief. For example, a December year end company taken over by a June year end company (and subsequently utilises sections 323D(3) and 323D(4)).

We also request that Treasury consider the wording of the synchronisation with parent clauses to ensure that companies preparing special purpose financial reports are not prevented from the benefit of this mechanism, that allows an 18 month financial year end for transition.

We have been made aware that some people have interpreted section 323D(3) and ASIC Information Sheet 17 in a similar manner to the consolidated SPFR and parent entity exemption mentioned above, so as to deny the use of the section to similar companies.

http://www.asic.gov.au/asic/asic.nsf/byheadline/Changing+a+financial+year?openDocument

Division 7—Financial years and half-years
323D Financial years and half-years

(3) A company, registered scheme or disclosing entity that has to prepare consolidated financial statements must do whatever is necessary to ensure that the financial years of the consolidated entities are synchronised with its own financial years. It must achieve this synchronisation by the end of 12 months after the situation that calls for consolidation arises.

APPENDIX 2 – Reasons the "Profits Test" is inappropriate as the measure for capacity to pay dividends

We detail below the many reasons why the "profits test" is no longer appropriate for use in relation to dividends, either for the Corporations Act or for taxation purposes.

In summary, these include:

a) Not all assets can be revalued under accounting standards. While case law permits unrealised profits from asset revaluations to be distributed, accounting standards were changed in 2005 to effectively prohibit revaluations of identifiable intangible assets (even though previous accounting standards permitted this). Accounting standards also prohibit the revaluation of value accretion through unidentified intangible assets, being goodwill.

b) Case law - There are difficulties with determining the appropriate case law and applying that case law to particular facts and circumstances. There are also questions as to whether the test is appropriate given changes to accounting standards and the changes to the share capital rules that occurred in the late 1990's.

c) While once profit recognised in financial statements may have been able to be used as a proxy for the accretion of value in a company, as the increase in the market price could be largely explained by the increase in profits recognised (and capital injections), this is no longer the situation. Consequently, a significant amount of the accretion in the value of companies is not recognised in financial statements, limiting the amount of dividends that should be able to be distributed from that accretion.

d) A company choosing to revalue assets in its financial statements (to recognise unrealised gains to meet the profits test) will have an ongoing burden of the revaluation treadmill, to keep the valuation up-to-date.

e) Many companies (over 98%) are not required to prepare statutory financial statements in accordance with Australian Accounting Standards. Consequently they are not able to readily determine what their statutory accounting "profits" are, with additional complications in applying the case law.

f) Profits under IFRS equivalent accounting standards (since 2005) are subject to much greater volatility. It is not clear under the case law whether profits available for dividend are also affected by this volatility from changed accounting standards.

g) It is not clear under case law whether intra-group transactions recognised directly in equity (through a contributions by owners account) are regarded as profits available for distribution as dividends or not.

h) Since 2005, companies issuing options and similar share-based payments have had to recognise an expense for the value for such payments. It is not clear under the case law whether profits available for dividend are reduced by these accounting adjustments.

i) It is not clear under case law how negative reserves, which exist under IFRS, affect the "profits test". We include an example below of a hedging reserve that includes unrealised losses that will be subsequently recognised in net profit, and a revaluation reserve under IFRS 9 that will not be subsequently recognised in net profit.

j) Changes in accounting standards since 1999 may be interpreted as requiring "current year" profits to be transferred to accumulated losses, before a dividend is recognised as a reduction of those profits. This may be interpreted as the "current year" profits losing their character as "current year" profits and consequently not being available for distribution.

k) Under case law, it appears that a distribution may be treated differently depending whether the dividend is made via cash or through non-cash assets (dividend in specie)

We discuss some of the above issues in relation to an example of "lost capital" and subsequent profits at the end of this Appendix.

a) Not all assets can be revalued under accounting standards.

Under the case law, dividends can be considered to be from "profits" if the dividend is recognised as a reduction of the asset revaluation reserve, subject to certain conditions.

Since the introduction of IFRS in 2005, Australian companies have effectively been prohibited from revaluing identifiable intangible assets like brand names, because of the restrictions under accounting standard AASB 138 *Intangible Assets* (in particular the active market test).

It is not clear from the case law whether Australian companies since 2005 are restricted in what can be classified as dividends (based on the profits test), because of this change in accounting standards that restricts what can be revalued.

We believe that a company should be able to distribute a dividend in circumstances where the value of the identified intangible assets has increased – just as they were permitted to do prior to 2005, subject to an applicable solvency test.

Accounting standards also prohibit the revaluation of goodwill (defined as unidentified intangible assets).

We believe that a company should be able to distribute a dividend in circumstances where the value of the goodwill has increased – subject to an applicable solvency test.

b) Case law

One of the major problems with the "profits test" is determining the applicable case law and interpreting it.

It appears that the legal opinion (by Slater and Hmelnitsky) issued by the ATO has identified the major applicable cases. However, it has only recently been released, and alternative opinions or differences of opinion to particular interpretations by other leading lawyers, have not yet been published.

Even with the cases identified, it is still very difficult to apply. We provide an example at the end of this Appendix.

We also believe that the case law, and consequently the "profits test" itself, is no longer appropriate given changes to accounting standards and the changes to the share capital rules that occurred in the late 1990's.

c) Profit is no longer representative of the accretion of value in a company

Until approximately the 1980s (recently in terms of case law), profits recognised in the financial statements of a company could be used as a form of proxy for the accretion in value of a company, as the increase in the market price could be largely explained by the increase in profits recognised (and capital injections).

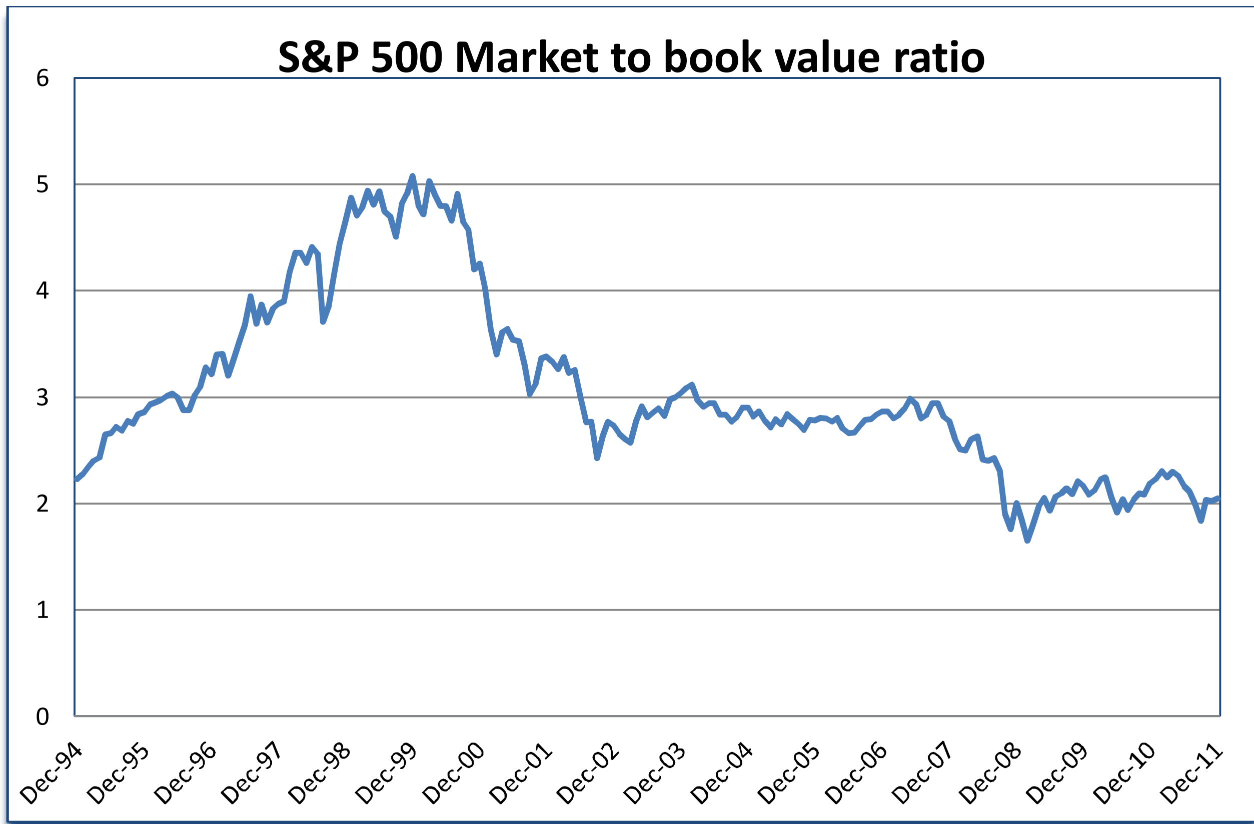
To illustrate, we sought to obtain statistics comparing the market value of listed companies to their book values. This comparison is often made on a company by company basis, with ratios comparing market value to NTA (Net Tangible Assets), or NAB (Net Asset Backing).

The ratio measures how much of the market value of the company is reflected in the financial statements of the companies. For example, a ratio of 2.00 indicates that the market value is 2.00 times book value. Therefore, a ratio of 2.00 shows that 1/2.00 (50%) of the market value is reflected in the financial statements. The financial statements will include the share capital of the company, recognised profits and reserves. Conversely, 50% of the market value is not reflected in the financial statements.

We did not identify a publicly available statistic for the Australian market. We calculated a ratio for the Top 50 Australian companies as at 30 June 2011, using data as at that date.

We arrived at a ratio of approximately 2.7. This shows that 1/2.7 (37%) of the market value is reflected in the financial statements, and conversely 63% of the market value is not reflected in the financial statements. This amount will be affected by the underlying composition of the Top 50, which has a heavy weighting for the mining industry and financial services.

We were able to obtain statistics for a wider market representation for the United States (Standard & Poor's 500) back to 1994. While the United States uses different accounting standards, a similar situation arises in that country. Below is a graph of the ratio of the market value to book value for the S&P 500:



As can be seen in the above graph, the ratio is almost always above 2, meaning that less than 50% of the market value of the company is recognised in the financial statements. Therefore, there is a significant amount of accretion in value of the company that is not recognised in the financial statements. This disparity has increased since the 1980's.

Using the financial statements as a measure of value accretion (profits) significantly understates the actual level of value accretion, and consequently the amount that could be regarded as distributable as dividends.

d) Burden of Revaluation Treadmill

Since 2001, companies that choose to revalue non-current assets (such as property, plant and equipment) have the additional burden of the revaluation "treadmill". The "treadmill" is the requirement to keep the carrying value at an up-to-date fair value. This often requires regular external valuations, at an obvious additional cost to companies.

Consequently, two companies with similar economic circumstances will have different "profits" available for distribution as a dividend under the "profits test", merely because of a choice under accounting standards. A company that incurs the additional ongoing burden of the revaluation treadmill, would meet the "profits test", yet a company that does not may be prevented from making a dividend.

We believe that companies with similar economic circumstances should have similar abilities to pay dividends.

When the case law for distribution of dividends from the asset revaluation reserve was established, this burden did not exist.

e) Many companies do not prepare statutory financial statements.

Following the changes to the Corporations Act in 1994 (also relatively recently in terms of case law), very few companies (less than 2%) prepare statutory financial statements.

The introduction of IFRS is also considered to have increased the complexity of accounting standards and the determination of profits.

Consequently, such companies are unlikely to be able to determine what "profits" are without expert assistance.

We believe that a simpler and cheaper set of requirements is needed, so as to not unnecessarily burden business with uncertainty and additional costs.

f) Volatility of profits

Profits under IFRS equivalent accounting standards (since 2005) are subject to much greater volatility. It is not clear under the case law whether profits available for distribution are also affected by this volatility from changed accounting standards. For example, before IFRS, many derivatives (including interest rate swaps and foreign currency contracts) were not fair valued, and therefore the profit determined under accounting standards may have been available for distribution per the case law. After IFRS, accounting profit may be increased or decreased from this volatility. It is not clear whether the profits distributable under case law are those that could have been determined under the accounting standards applicable before IFRS (generally when the case law was established), or are affected by the IFRS adjustments.

Other significant causes of volatility include impairment losses (and reversals) that are now recognised earlier than under the "permanent diminution" approach of earlier years.

g) Contributions by owners' accounts

Under IFRS equivalent accounting standards a number of intra-group transactions may be recognised directly in equity. An example is the recognition of assets and liabilities transferred from another group entity for no consideration. In these circumstances, the assets and liabilities are recognised at amounts required under applicable accounting standards, and the difference recognised in equity.

If the increase is positive, it is not clear under the case law if the amount is "profits" and therefore available for distribution under the "profits test". Accounting standards merely require the increase to be recognised in equity. Accounting standards do not specify whether the increase is an increase in share capital (which might be included under contributed equity in the financial statements), a reserve, or something else.

In other situations, the difference may be negative. It is not clear from the case law whether a negative amount is in effect a reduction of share capital, a reduction in profits available for distribution as a dividend under the "profits test", or something else.

Another example of a common situation that causes the need to recognise an amount in equity (usually for subsidiaries) is from interest free loans, where the cash received is the principal amount, but the accounting standards often require a discounted amount recognised as a liability. The difference is recognised in equity.

h) Share-based payments

Since IFRS was introduced in 2005, companies issuing options and similar share-based payments have had to recognise an accounting expense for a value for such payments. In many circumstances, if the options do not vest with the employee because the service criteria, or other performance hurdles are not met, the expense is later reversed.

The offsetting entry to the expense is usually to equity. The amounts recognised in equity are often accumulated in a reserve titled "share-based payments reserve" or "employee option reserve" or similar.

It is not clear from the case law (established generally before IFRS) whether profits available for distribution for a current year are affected by these adjustments to accounting profits, and whether the share-based payments reserve is available for distribution.

i) Negative reserves

The use of negative reserves is now part of Australian Accounting Standards under IFRS. Examples include the hedging reserve, the AASB 9 revaluation reserve and AASB 119 pensions reserve.

It is not clear from the case law (established generally before IFRS) how profits available for distribution are affected by these negative reserves.

Hedging reserve

The underlying requirement of AASB 139 *Financial Instruments: Recognition and Measurement* is to measure derivatives (including interest rate swaps, foreign currency and some commodity contracts) at fair value, which requires the recognition of unrealised gains and losses on these contracts.

The hedging reserve (which may also be referred to as the cash flow hedge reserve) is used to defer unrecognised gains and losses on derivatives in some circumstances.

The use of a hedging reserve is not mandatory under current accounting standards. Indeed, it may be considered a privilege to use hedge accounting. The requirements to use hedge accounting are quite onerous, with the need to meet designation requirements, documentation requirements, and continuing effectiveness requirements (both from a prospective basis, and a retrospective basis, often using an hypothetical derivative approach).

The requirements are often considered too onerous for many companies, who may not bother following, or trying to understand, the requirements.

The outcome of difficulties of meeting the hedging requirements of the accounting standards, is that there can be dramatically different accounting results for the same economic transactions.

For example, two companies with an accounting profit of $12 million before the IFRS fair value adjustment for interest rate derivatives. Each company incurs a $2 million loss on this book value adjustment, of which Company A does not use hedge accounting, and Company B does (and complies with hedging requirements). The results are reported as follows:

Company A and Company B (pre IFRS)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	Nil (not recognised)
Net profit	12 million

Company A (after IFRS, no hedge accounting)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	(2 million)
Net profit	10 million

Company B (after IFRS, with hedge accounting)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	Nil (recognised in equity)
Net profit	12 million
Hedging reserve	(2 million)

It is not clear whether Company A has profits available for distribution as $10 million or $12 million or something else.

Modifying the above example for an unrealised profit rather than an unrealised loss, the results are reported as follows:

Company A and Company B (pre IFRS)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	Nil (not recognised)
Net profit	12 million

Company A (after IFRS, no hedge accounting)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	2 million
Net profit	14 million

Company B (after IFRS, with hedge accounting)	
Profit before market-value adjustment	12 million
IFRS market-value adjustment	Nil (recognised in equity)
Net profit	12 million
Hedging reserve	2 million

It is not clear whether Company A has profits available for distribution as $12 million or $14 million or something else.

Revaluation Reserve – AASB 9

Negative reserves can also be created under the revised financial instruments standard AASB 9 *Financial Instruments*. This standard is expected to be mandatory for financial years beginning on or after 1 January 2015 (based on recent amendments by the International Accounting Standards Board (IASB) being approved by the Australian Accounting Standards Board (AASB)).

Under AASB 9 companies will be required to fair value investments in equity instruments (e.g. shares). The default accounting is to recognise these unrealised profits and losses in profit. Companies can choose to recognise those mark-to-market movements, including what would be recognised as impairment losses in net income under current standards, in an equity reserve. The standard prohibits subsequent recognition of those gains or losses in net profit, even if the equity instrument is sold.

Similar to the hedging reserve above, a choice under accounting standards for similar economic circumstances, can result in different accounting profits and what may be interpreted as different amounts available for distribution as a dividend under the "profits test".

Pensions Reserve – IAS 19 (revised)

Negative reserves can also be created under the revised AASB 119 *Employee Benefits*. This standard will be mandatory for financial years beginning on or after 1 January 2013.

j) Dividends – change in recognition and roll-over into accumulated profits.

One of the practical problems with the "profits test" is the time when profits are transferred to accumulated losses, and whether those profits are later available for distribution as a dividend.

The transfer of profits to accumulated losses may be regarded as those profits losing their character as profits and being ineligible for distribution as a dividend from "profits".

When the case law was established for distribution of dividends from current year profits, when accumulated losses existed, the accounting standards permitted the recognition of a future dividend (from current period profits) as an appropriation of current year profits and a dividend payable.

Therefore, effectively it was only the net amount that was transferred to accumulated losses.

Since 1999, future dividends from current year profits are usually not able to be recognised as a dividend payable, or an appropriation of current year profits. So technically, the current year profits are transferred to accumulated losses before the dividend is recognised.

It is not clear from the case law whether the change in accounting standards means that current year profits lose their character immediately if recognised for a financial year as being transferred to accumulated losses, before the dividend is recognised as a reduction of those profits.

On the assumption that a dividend paid very soon after year end can be attributed to the previous year profits, there is the issue as to what length of time is available for such attribution before the profits lose their character as profits and are absorbed into accumulated losses.

k) Distribution cash vs non-cash assets

We noted above difficulties with the "profits test" with dividends from unrealised profits, which mainly can be achieved through the use of an asset revaluations reserve.

The Slater and Hmelnitsky opinion refers to the *Condell v FC of T* (2007) 66 ATR 100 case. That case appears to be decided in relation to the tax treatment rather than under the Corporations Act or "profits test".

Under the decision, a dividend (in that case a distribution in specie) was regarded as a dividend from profits, even if the whole of the market value of the dividend was not recognised as a reduction in retained earnings.

While it is not clear from the case, it would appear that potentially if a company distributed a non-cash asset as a dividend (in specie), it would be regarded as being from profits, yet if the company made a cash distribution, the amount may not be regarded as being from profits (if realised profits were not sufficient).

We believe that a dividend, irrespective of whether it is distributed through cash or in specie, should have the same treatment.

We do not see any economic difference to a company distributing an asset with a market value (of say $1 million) and a company distributing cash of $1 million. In both cases, the economic resources of the company have been reduced by $1 million.

Example showing the difficulties arising from these factors – company with "lost capital" and subsequent profits

In the example below, the company had original capital of $1,000,000 but subsequently incurred losses of $600,000. The company then earned $330,000 in accounting profits in the subsequent 3 years, and also recognised an asset revaluation reserve of $200,000.

Under case law, a company that incurs accumulated losses does not have to make up "lost capital" if it earns subsequent profits.

Also as noted above, there is uncertainty as to what amount of subsequent profits are available for distribution if such profits have been transferred to accumulated losses.

The statutory financial statements of the company would show the following:

Share capital	1,000,000	
Accumulated losses	(270,000)	
Asset revaluation reserve	200,000	
		930,000

If the company wanted to distribute a dividend of $100,000 it is not clear whether this would be permitted under the "profits test".

We understand that under the "profits test" case law, even though there is an asset revaluation reserve, any "trading losses" need to be absorbed first, indicating that the asset revaluation reserve was not available.

Also, it could be interpreted that as the previous year profit was transferred to accumulated losses, it was also not available.

However, the equity of the company could also be viewed as the following:

Ordinary share capital originally invested	1,000,000	
Capital "lost" (Accumulated losses to year X0)	(600,000)	
		400,000
Net profit after tax year ended X1	100,000	
Net profit after tax year ended X2	110,000	
Net profit after tax year ended X3	120,000	
Asset revaluation reserve post X0	200,000	
Realised and unrealised profits recognised in financials post X0		530,000
Shareholders equity prior to distribution		930,000

As can be seen above, it is relatively easy to identify the profits earned since X0. It should also be noted that there have not been other movements in accumulated losses, e.g. profits in some years, and losses in other years that might cause confusion as to the source of profits.

If applying the "profits test", and trying to determine what level of dividends could be distributed as profits, issues include:

- Can the accumulated losses as at X0 be considered lost capital at that time?
- Can the profits earned since X0 be considered available for distribution, even though they have been transferred to accumulated losses?
- The need to absorb "trading losses" prior to utilising any asset revaluation reserve
- Can the asset revaluation reserve recognised since X0 be considered available for distribution (as unrealised profits)?

We believe that the uncertainty needs to be removed so that directors can confidently determine their Corporations Act requirements and the taxation outcomes of transactions.