SIGNIFICANT REFORMS TO THE DIVIDENDS TEST

29 April 2014 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings – By **Paul Branston** and **Richard Hendriks**

SUMMARY

- Treasury has released an Exposure Draft of legislation including proposed amendments to the dividend payment provisions of the Corporations Act.
- The proposed amendments replace the current net assets test with a pure solvency test.
- The proposed amendments also make clear that share capital can be reduced by the payment of a dividend (without the need for shareholder approval).
- The source of dividends paid and the company's dividend policy will need to be included in the annual report.
- The amendments are not intended to change the existing taxation arrangements, so the tax implications of paying a dividend from share capital will need to be carefully considered before paying a dividend on the basis of the proposed provisions.

BACKGROUND

Section 254T of the Corporations Act, which governs the circumstances in which a dividend may be paid, has been the subject of a range of reform and proposed reform, in recent years.

Section 254T initially provided that dividends could only be paid out of profits. However, changes in accounting standards impacted upon the calculation of profits, limiting companies' ability to pay dividends under the profits based test. This, and practical difficulties in determining what were 'profits' eventually led the 'profits test' being replaced with the current 'net assets test' in 2010, consistent with a move towards relaxing of the capital management doctrine in Australia.

The current net assets test provides that dividends may not be paid unless:

- the company has positive net assets before the dividend is declared and those assets are sufficient for payment of the dividend
- the payment of the dividend is fair and reasonable to the company's shareholders, and
- the payment does not materially prejudice the company's ability to pay its creditors.

Some commentators have noted that the focus of the test on net assets (in addition to solvency), means some smaller companies that are not required to prepare financial statements cannot benefit from the flexibility the net assets test was intended to provide without the additional compliance burden of preparing accounts. Adopting a balance sheet focused test as an overlay to solvency can also be problematic. For example, a company with strong cash flows may be solvent and capable of paying a dividend, but due to assets with low historical book values may be prevented from paying a dividend under the net assets test.

OVERVIEW OF THE PROPOSED CHANGES

New solvency test

The proposed amendments to section 254T in the Exposure Draft of the Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014 propose to replace the net assets test with a pure solvency test. That is, if the directors of the company reasonably believe that the company will remain solvent after the payment of the dividend, then the company may pay the dividend.

The proposed amendments also draw a distinction between a declaration of dividends by the company and the payment of dividends by the company. Given it is now common practice to determine, rather than declare, a dividend, as permitted by section 254U of the Corporations Act (and most company constitutions), this distinction will unlikely have a significant role in practice.

Clarification of payment of dividends from capital

On one view there is currently ambiguity regarding whether a dividend paid other than out of profits in reliance on the net assets test is a capital reduction that also requires shareholder approval under the capital reduction provisions of Chapter 2J of the Corporations Act.

To remove the ambiguity on this point, the proposed amendments include a new section 254TA which expressly allows a company to reduce its share capital by the payment of a dividend (ie. pay a dividend other than out of profits). When read with Chapter 2J, which applies to reductions of share capital 'not otherwise authorised by law', it is clear that shareholder approval is not required for a dividend that reduces share capital provided the dividend meets the requirements of an equal reduction of capital. Those requirements are:

- the capital reduction must only relate to ordinary shares
- the capital reduction must apply to each holder of ordinary shares in proportion to the number of ordinary shares they hold, and
- the terms of the reduction must be the same for each holder of ordinary shares (subject to limited exceptions).

Reporting requirements

The proposed amendments require that if dividends are paid other than out of profits the directors' report in a company's annual report must include details about the source of dividends paid where they are paid and the company's dividend policy for determining the amount and source of dividends.

TAX CONSIDERATIONS

The explanatory statement to the Exposure Draft states that the proposed amendments are not designed to change existing taxation arrangements. This means that, for example:

- share capital reductions by way of dividends will generally continue to not be dividends for income tax purposes and thus will not be assessable as a dividend or frankable (rather, a shareholder's cost base in the shares is reduced or a capital gain may arise). As a consequence, there may need to be separate disclosure in dividend statements to shareholders of the amount that is a dividend for corporate law purposes and the amount that is a dividend for income tax purposes (the specified franking percentage will relate to the amount that is a dividend for income tax purposes, rather than the total amount of the corporate law dividend)
- dividends (for tax purposes) will continue to be unfrankable if they are attributable to (sourced indirectly from) share capital – the payment of a dividend that resulted in, or increased, negative retained earnings would still likely be regarded by the Australian

Taxation Office (ATO) as attributable to share capital, and

- a tax integrity rule (section 45B) can apply where a return of capital is made in substitution for a tax law dividend, the consequences of which is that the return of capital is re-characterised as an unfrankable dividend. Accordingly, a ruling from the ATO will generally still be required where a return of share capital is undertaken by way of a dividend.

WHERE TO FROM HERE?

The proposed amendments are aimed at increasing the flexibility of companies to pay dividends, and they achieve this by removing the positive net assets requirement of the net assets test in favour of a pure solvency test (noting that a solvency test was already one limb of the net assets test).

Solvency is a well understood concept and the amendments replace a balance sheet focused test with a cash flows test, which would appear to be the most appropriate test when considering whether a company should be permitted to pay funds to shareholders.

It will be worth companies considering whether the dividend payment provisions in their constitution are not more restrictive than the new proposed test. In our experience, following the 2010 amendments, the power to pay dividends is relatively broad in most constitutions, which may minimise the need for amendments to constitutions in most cases.

Treasury has announced a 5 week consultation period, with submissions closing on 16 May 2014. It will also be interesting to see the ATO's response in respect of the assessability and frankability of dividends when the legislation is passed (particularly as last time section 254T was amended, the ATO issued a 36 page tax ruling together with a 39 page QC's opinion).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

PAUL BRANSTON

PARTNER, PERTH

+61 8 9211 7880
Paul.Branston@hsf.com

LEGAL NOTICE