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Our ref Treasury-submission-2014-05

16 May 2014

Dear Sir/Madam

Submission - Exposure Draft - Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014

We are pleased to have the opportunity to comment on the Exposure Draft ('ED') of the *Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014* and associated commentary as released by the Acting Assistant Treasurer on 10 April 2014.

Executive summary

Dividend amendments

Overall we welcome the movement to a solvency test for the payment of dividends. This change should assist in improving the effective operation of the Corporations Law and in part reduce regulatory burden. In particular, the removal of the link in the 'net asset' tests to Australian accounting standards will benefit a number of groups.

Our main concerns with the changes proposed in the ED are related to the drafting of the dividend provisions and the related taxation implications, including:

- redrafting sections 254T and 254TA to an authorising provision which would override a company's constitution
- redrafting section 254TA to take account of issues when a company has more than one class of share capital on issue
- providing further clarification of the meaning of 'share capital'
- income tax interactions
- additional Directors' Report disclosures
- the proposals do not address past practice by companies that may have paid a dividend on the basis of legal advice that section 254T overrides Part 2J.1.

Refer to Appendix 1 for further comments.

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Holding of general meetings

We support the amendments as proposed.

Remuneration reporting

We support the amendments as proposed. However, we note that the issues we advised in our letter of 31 March 2014 regarding the transfer of individual key management personnel disclosures from the financial statements to the remuneration report have not been addressed. A copy of this letter to Senator the Hon Mathias Cormann is attached in Appendix 3. We urge you to resolve these issues as a matter of urgency given they will apply at 30 June 2014.

Auditor appointment for companies limited by guarantee

We support the amendments as proposed. However consistent with our 2012 submission on Treasury's 2011 *Discussion Paper: Proposed Amendments to the Corporations Act*, we urge Treasury to clarify the definition of a small company limited by guarantee as provided in section 45B.

Refer to Appendix 2 for further comments.

Changes in financial years

We support the amendment proposed. We consider that the clarity being sought could be extended to subsection 323D(1) and first financial years which are less than 12 months. Once again this clarity would not change the operation of the current law.

* * * * *

We would be pleased to discuss our comments with staff of The Treasury. If you wish to do so, please contact Kris Peach on (03) 9288 5297 or Michael Voogt on (02) 9455 9744.

Yours faithfully

Martin McGrath
Partner in charge, Department of Professional Practice

Appendix 1 – Dividend Amendments in Exposure Draft – Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014

We welcome the proposed amendments which replace the current 'net asset' rules with a 'solvency' test. This will remove the current link between the ability to pay a dividend and Australian accounting standards which we supported in our 2013 submission to Treasury's 2012 ED on *Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill 2012*. The change will assist in reducing the compliance burden for companies that are not otherwise required to apply Australian accounting standards (for example, small proprietary companies).

We further welcome the clarity provided by the proposed amendments for companies which determine, as opposed to declare dividends.

Our main concerns with the changes proposed in the ED are:

- redrafting sections 254T and 254TA to an authorising provision which would override a company's constitution
- redrafting section 254TA to take account of issues when a company has more than one class of share capital on issue
- providing further clarification of the meaning of 'share capital'
- income tax interactions
- additional Directors' Report disclosures
- the proposals do not address past practice by companies that may have paid a dividend on the basis of legal advice that section 254T overrides Part 2J.1.

Authorising provision

Section 254T is still drafted as a prohibitive provision. We would recommend that the legislative wording of section 254T should be changed to an authorising provision which would override a company's constitution. This would aid in further reducing the compliance burden on companies.

Many companies have constitutions that allow dividends to be paid out of profits. Some companies updated their constitution as a result of the 2010 amendments (*Corporations Amendment (Corporate Reporting Reform) Act 2010*) to section 254T. Unless the new wording in sections 254T and 254TA override company's constitutions, individual companies will need to update their constitutions again.

Section 254TA and meaning of 'equal reduction'

An issue exists with the current drafting of the proposed section 254TA around the ability to pay a dividend that results in a reduction in share capital where a company has other classes of issued capital, for example, preference shares (with or without terms which entitle the holders to dividends before payment of a dividend to ordinary shareholders) or even 'A' and 'B' class ordinary shares. As noted above, the 'equal reduction' requirement in the proposed section 254TA only permits the reduction of share capital for dividends on ordinary shares. Does the proposed wording mean that section 254TA could not be used by some companies purely because they have more than one class of share capital on issue? We recommend that the wording be changed to equal reduction for all shareholders in the "relevant class of share capital" that the dividend is paid on.

Section 254TA and meaning of 'share capital'

A further issue around the current drafting of the proposed section 254TA is what is meant by the term 'share capital'. This term is not currently defined by the Corporations Act or Australian accounting standards, albeit case law exists. If the focus of these proposed amendments is to assist with improving efficiencies and reducing regulatory burden, then guidance to address the following would be of benefit:

- What is the quantum of share capital when a company has accumulated losses? For example, a company has $100 in issued capital and accumulated losses of $20. Is the share capital $100 or $80?
- What is considered to be part of share capital, i.e. it would seem that profits are not considered part of share capital but what about:
  - items of other comprehensive income such as asset revaluation reserves or foreign currency translation reserves
  - reserves such as share-based payment reserve and general reserves?
- Are there two sources of funds from which dividends could be paid – profits and share capital? If so, how is this impacted by the reserves discussed above? For example is it possible to pay a dividend out of a 'temporary' asset revaluation reserve either under the proposed section 254T or section 254TA?

In KPMG's view the proposed legislation should be clarified to resolve the above uncertainties.

Income tax interactions

The ED does not address all concerns raised about the operation of section 254T, and its interaction with tax legislation. The explanatory material merely notes the proposed amendments are not designed to change the existing taxation arrangements. So is a dividend frankable if it is sourced from profits (including current year profits), and not frankable if not sourced from profits?

KPMG supports legislative amendments in the dividend area. The interaction between the proposed sections 254T and 254TA and the ability to pay franked dividends continues to be a difficult area for entities. KPMG supports initiatives to provide clarity in this most important commercial area.

Effectively, if the taxation issues are not addressed, companies will still be subject to a dual solvency and profits test when determining or declaring dividends. We acknowledge the difficulty in amending taxation requirements.

However, concurrent with finalising the proposed amendments to the Corporations Act we recommend that there should be a short consultation process on the taxation interactions as some income tax law changes might still be required or worth considering in order to resolve uncertainties and reduce regulatory burden. For example:

- A number of provisions in the *Income Tax Assessment Act* ('ITAA') *1936* and *1997* which make reference to the term 'profits' and which may require consideration and possible amendment as a consequence of any move away from a profits based test for the payment of dividends.
- The fact that, on the face of it, the 2010 amendments and, in particular, the insertion of section 44(1A) to the ITAA 1936, has resulted in capital distributions to partners of a corporate limited partnership being taxed as dividends as they are deemed to be paid out of profits.
- Some taxation administrative guidance will require updating. In particular Tax Ruling 2012/5 *Income tax: section 254T of the Corporations Act 2001 and the assessment and franking of dividends paid from 28 June 2010* will need to be refreshed. For example, the impact of the above Corporations Act discussion on dividends paid from profits and share capital. The current tax ruling suggests that dividends can only be paid out of profits.

Additional Directors' Report disclosures

Neither the Corporations Act or the ITAA define the term 'profits'. Instead legal precedents need to be considered. The majority of these precedents are outdated and complex and arguably not in line with current Australian accounting standards, which are increasingly linked to fair values. This causes unnecessary costs and difficulties for directors. We also note that Australian accounting standards are not clear in their concepts of what "profit" represents, as there is an additional wider notion of "comprehensive income", which is arguably a better reflection of performance during a period.

The proposed amendment requires that, when dividends are paid out of sources other than profits, details of the company's dividend policy for determining the amount and source of dividends must be included in the Directors' Report. KPMG recommends that Treasury provide directors with specific guidance, including examples, of the extent of disclosures required by this proposed amendment. Alternatively the disclosures required could be an explanation of the framework applied when determining dividends.

Transitional rules

The amendments propose transitional requirements where the current section 254T will apply to dividends declared, and not as yet paid, before the commencement date of any amending Act. However, the proposals do not address past practice by companies that may have paid a dividend on the basis of legal advice that section 254T overrides Part 2J.1.

KPMG urges Treasury to consider providing directors with a "transitional no prejudice" rule for both corporations and income tax law in the event that they have paid dividends on the basis that existing section 254T authorised the payment of dividends out of capital. In our view this is appropriate given the intention of the 2010 amendments (*Corporations Amendment (Corporate Reporting Reform) Act 2010*) and the differing views which have subsequently emerged in relation to their effect.

Other

The ED does not address whether the existing rules governing the redemption of redeemable preference shares in section 254K remains appropriate. Given the proposed amendments to section 254T and the creation of section 254TA it would seem appropriate to review the requirements around the redemption of redeemable preference shares.

Appendix 2 – Auditor Appointment for Companies Limited by Guarantee in Exposure Draft – Corporations Legislation Amendment (Deregulatory and Other Measures) Bill 2014

The proposed amendment exempts small companies limited by guarantee, and companies limited by guarantee that elect to have their accounts reviewed rather than audited, from the need to appoint or maintain an auditor. We welcome this administrative relief.

However, the ED proposes no changes to the definition of a small company limited by guarantee as provided in section 45B, so there remains confusion as to whether a company meets the small test.

The wording in section 45B(1)(c) states that to be 'small', where the company limited by guarantee is required by accounting standards to be included in consolidated financial statements, the consolidated revenue of the consolidated entity should be less than the threshold amount. The issue is around interpretation of what revenue amount should be compared for an entity that is itself a subsidiary.

If we look at the following example:

- Assume that both Company A and Subsidiary C are companies limited by guarantee and Subsidiary B is a large proprietary company. Company A controls subsidiaries B and C. There are no other entities in the group.
- For Company A the revenue in its consolidated financial statements is the amount to compare against the defined threshold amount.
- For Subsidiary B the revenue in its financial statements is the amount to compare against the defined threshold amount in section 45A.
- However for Subsidiary C, should the revenue test under section 45B be on the revenue:-
  - in the financial statements of Subsidiary C itself; or
  - in the consolidated financial statements of Company A?

At present we believe there is inconsistent application of the above. It is arguable that the intent of the wording in section 45B(1)(c) is not clear and that the Explanatory Memorandum to the *Corporations Amendment (Corporate Reporting Reform) Act 2010* implied the test would be consistent with testing for determining small proprietary companies under section 45A, i.e. in the above example look at the revenue of Subsidiary C only.

KPMG considers that Treasury should amend the Corporations Act to clarify that the test was intended to operate as section 45A operates.

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Senator the Hon Mathias Cormann
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31 March 2014

Dear Sir

Corporations and Related Legislation Amendment Regulation 2013 (No. 1)

We would like to raise a number of concerns arising from the above Corporations Regulation Amendment (the Amendments) relating to Corporations Regulation 2M.3.03 issued in June 2013. These concerns are set out in the Appendix, together with our recommendations for addressing the concerns.

The Amendments purported to incorporate disclosure requirements, relating to certain transactions with the key management personnel of disclosing entities that are companies, from AASB 124 *Related Party Transactions* (AASB 124). The original explanatory memorandum advised that:

> "The proposed Regulation inserts these disclosures into the *Corporations Regulations 2001* to ensure that disclosure continues. The complete removal of the disclosures would create information gaps in the regulatory framework."

We understood the intention of the Amendment was to transfer the disclosures that were previously included in the notes to the annual financial statements into the entity's remuneration report. We do not believe there was any intent to increase or dilute the existing level of disclosure.

However, the wording used in the final Amendments is different to that used in AASB 124. In three particular areas, these differences in wording result in unintentional expansion of disclosures required, dilution of information by grouping dissimilar transactions, and decreased clarity in the disclosures required. With the requirements being less clear, there is also a risk that companies will interpret the requirements multiple ways, creating diversity in practice where previously practice was largely uniform.

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Specifically, the differences in wording results in the following:

- Significant increases in the disclosure of key management personnel's holdings of and transactions in equity instruments. Taken literally, the Amendments now require disclosure of any equity holdings of key management personnel. Previously the disclosures only related to equity instruments of the disclosing entity, not their entire portfolio of equity instruments. We believe that the disclosure is intended to be limited to holdings of equity instruments in the disclosing entity.

- The Amendments do not require disclosure of equity holdings and transactions by class of equity instrument. Previously, AASB 124 required disclosing entities with multiple classes of equity – for example, ordinary shares and preference shares –to disclose details about them separately by class. The Amendment does not replicate this requirement. Therefore, a disclosing entity could just add the numbers of ordinary shares and preference shares together into one table.

- If we consider the above two concerns together, a disclosing entity could add all equity instruments held by a member of key management personnel in to a single disclosure: holdings of 100 ordinary shares of the disclosing entity, 100 preference shares of the disclosing entity and 100 shares of an unrelated company could be disclosed as a holding of 300 shares. The aggregation of the classes of equity instruments, plus the requirement to disclose holdings of equity instruments that are irrelevant to the consideration of a disclosing entity's transactions with its key management personnel would make the information meaningless to a shareholder.

- By expanding (albeit, we believe the expansion was not intended) the scope of the disclosure requirements, disclosing entities face increased costs of gathering and preparing the information. In addition, information in a remuneration report is subject to an audit, which will now take additional time and incur even further costs to the disclosing entity. Taken together, these additional costs will be incurred for providing information that is irrelevant to shareholders who are considering how a disclosing entity remunerates and transacts with its key management personnel.

- In the Amendments, guidance from AASB 124 has been reworded in a way that makes it less clear how to disclose transactions that involve limited recourse loans to purchase shares of a disclosing entity. These arrangements are very common in the remuneration practices of listed companies, where they are used as a form of equity compensation. We are concerned that the reworded guidance will result in diversity in practice, because it is not clear that such arrangements should be disclosed as part of the remuneration disclosures, rather than under the category of loans to employees.

We are concerned that disclosing entities looking to implement these requirements will either:

1) Follow the Amendments literally by increasing the transactions disclosed and grouping them together, weakening the usefulness of the disclosures that have been provided to shareholders in the past and incurring additional costs to provide disclosure that is not relevant to the remuneration process, or

2) Ignore the requirements of the regulation and continue providing the disclosures without regard to the actual requirements of the Regulation, resulting in a remuneration report that does not comply with the Corporations Act, or

3) Make the disclosures that are literally required, but then provide additional disclosure to explain why the required disclosures are not relevant to shareholders. This means expansion of a remuneration report in order to address information that should not be disclosed in the first instance.

Disclosing entities with 30 June 2014 year ends will be preparing the first round of remuneration reports that will need to comply with the Amendments. We urge you to make the recommended amendments to the Corporations Regulations prior to 30 June 2014, so that these disclosing entities will be able to provide shareholders with useful information at the right level of detail, without incurring additional costs to provide information that is irrelevant to the consideration of a disclosing entity's remuneration practices.

We have discussed our concerns with Treasury and would be pleased to assist in any way to facilitate a timely resolution of these concerns. Please contact Sarah Inglis on (02) 9455 9773 or me on (02) 9335 7630 if we can assist.

Yours faithfully

Martin McGrath
Partner

Copy to:
Ms Diane Brown, General Manager, Governance and Insolvency Unit, Corporations and Capital Markets Division, The Treasury
Mr Aaron Jenkinson, Acting Manager, Governance and Insolvency Unit, Corporations and Capital Markets Division, The Treasury

Appendix

Our suggested changes to address the concerns raised are set out below. Our suggested changes simply reflect the wording from AASB 124 *Related Party Disclosures*.

Issue: disclosure of equity holdings of key management personnel

AASB 124 paragraph Aus29.7 has not been correctly reflected in Item 18 of the Regulation in relation to the qualifying words, "issued or issuable by the disclosing entity and any of its subsidiaries". The Regulation could therefore be read such that disclosure is required in respect of any equity instrument of any entity.

Recommendation

Amend the Regulation by including the above italicised words in Item 18 (as is done for Item 17).

Issue: level of detail required for disclosures of equity holdings and options and rights holdings

AASB 124 paragraph Aus29.7 has not been correctly reflected in Items 17, 18 and 19 of the Regulation. This paragraph is already included in the Regulations as 2M.3.03(3) in relation to existing Items 15 and 16. Without expanding 2M.3.03(3) to Items 17, 18 and 19, some entities may not separate their disclosures by class of equity instrument.

Para Aus29.7 required the disclosures to "be separated into each class of equity instrument identifying each class by:

a. The name of the issuing entity

b. The class of equity instrument

c. If the instrument is an option or right, the class and number of equity instruments for which it may be exercised."

Recommendation

Amend the Regulation by expanding the scope of Regulation 2M.3.03(3) to include Items 17, 18 and 19.

Issue: Subregulation 2M.3.03(3A) – transactions involving non-recourse or limited recourse loans to purchase shares

The original AASB 124 wording was clear that non-recourse loans to purchase shares were outside the scope of the disclosures about loans provided to key management personnel required by AASB 124 Aus29.8 and 29.8.1. Instead, these arrangements formed part of the remuneration transaction disclosures. Without clarifying the requirement of Regulation 2M.3.03(3A), some entities may disclose limited- or non-recourse loan transactions as both a pure lending transaction and as a remuneration transaction, or may only disclose the transaction as a lending transaction implying there is no element of remuneration.

Recommendation

The following proposed replacement 2M.3.03(3A) will address the risk of diversity in practice and address the reluctance of the drafters to use the words "in substance options" in the Regulation:

"For items 20 and 21 of the table in subregulation (1), loans do not include limited- or non-recourse loans involved in transactions to purchase equity instruments."