

Submission on Treasury Discussion Paper 'Proposed Amendments to the Corporations Act'

Summary

This submission is made by the Head Office Advisory Team at Freehills in response to the **Discussion Paper** released by Treasury on 28 November entitled 'Proposed Amendments to the Corporations Act'. The Discussion Paper acknowledges stakeholder concerns raised in relation to the **new test for payment of dividends** introduced in the June 2010 amendments to the Corporations Act.

We note that Treasury has put forward four options for dealing with the dividends test, and has identified other issues for consideration. In this submission, we do not consider the four options put forward by Treasury, but instead focus on three of the issues for consideration Treasury has identified in the Discussion Paper, which we believe require consideration regardless of which option is ultimately adopted.

The three issues we believe must be addressed in any amendment to s 254T are follows:

- 1 **interaction between the dividends test and capital reduction rules:** in our view, the interrelation of s 254T and the capital reduction rules in Chapter 2J.1 is ambiguous and requires clarification at the legislative level;
- 2 **use of 'declared' in the dividends test:** in our view, the requirement in s 254T that a dividend be 'declared' is outdated, and should be removed from the test and replaced with 'determined' or 'resolved'; and
- 3 **consistency between the positions of Treasury and the ATO:** recent statements issued by Treasury and the ATO differ substantially on the operation of s 254T. The effect of the new dividends test on franking credits is a crucial issue to our clients, and a standard government position is highly desirable.

Each issue is dealt with in turn below by first noting the issue for consideration as identified in the Discussion Paper, then Treasury's view on the issue, then Freehills' response.

1 Interaction of dividends test and capital reduction rules is unclear

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' (p 10 of Discussion Paper).

Treasury's view: 'The Treasury believes the legislative provisions are clear. However, the concern raised by some stakeholders suggests that there may be merit in either amending the legislation or inserting a note to clarify the inter relationship between the operation of the dividends test and the capital maintenance provisions' (p 10 of Discussion Paper).

Freehills' response: Notwithstanding Treasury's view that the legislative provisions are 'clear', our experience is that the interaction of the dividends test in s 254T and the capital reduction rules in Chapter 2J is a source of genuine confusion for both clients and legal experts. Our best reading of the relationship between the new s 254T and Chapter 2J.1 is that the procedures to approve a share capital reduction still need to be met for a company to pay a dividend not prohibited by section 254T that is sourced from share capital.

In our view, regardless of which approach to the dividends test is ultimately adopted, legislative amendment is needed in order 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' under the capital reduction rules.

2 'Declaring' a dividend should not be necessary to satisfying the test

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' (p 9 of Discussion Paper).

Treasury's view: 'In the event that stakeholders consider that the dividends test should include a solvency test, it is Treasury's view that section 254T should continue to use 'declared' as an element of the test will be that a company must not pay a dividend unless the directors are satisfied that the company's assets will exceed its liabilities after the dividend is declared' (p 9 of Discussion Paper).

Freehills' response: in our experience, it is increasingly rare that clients 'declare' a dividend, now that s 254U provides for the board to 'determine' that dividends are payable. We believe that this reflects current market practice, as it is rare for contemporary constitutions to require that a dividend be 'declared'. This decision to 'determine' a dividend rather than 'declare' is often deliberate – in order to ensure that the debt does not arise until the time fixed for payment has arrived and so that the dividend can be revoked before that time.

Even if it is ultimately decided that the dividends test should include a solvency test, we do not think that it is necessary that section 254T continue to use the term 'declared'. We understand that the solvency test needs to be meaningful and that therefore the dividend needs to be a liability of the company so that the payment of the dividend will be taken into consideration when applying the solvency test. However the legislation can be drafted so as to require that the dividend be treated as a liability of the company for the purpose of determining whether the solvency test has been satisfied. In this way the solvency test will work in the same manner, regardless of whether the dividend has been declared or determined by the Board.

3 Treasury and the ATO appear inconsistent

Issue: 'some stakeholders have raised concerns about uncertainty that exists amongst the Australian business community in relation to dividend payments and whether or not they are capable of being franked for tax law purposes' (p 11 of the Discussion Paper).

Treasury's comment: 'Concerns about the ability of companies to pay franked dividends since the corporations law amendments arise, at least in part, from draft fact sheets issued by the Australian Tax Office (ATO) to an industry stakeholder working group... the ATO has advised that a draft Taxation Ruling is being considered by the Public Rulings Panel at the end of November 2011'.

Freehills' view: on 21 December 2011, the ATO released the draft Taxation Ruling referred to by Treasury above (Draft Taxation Ruling TR 2011/D8, 'Income tax: Section 254T of the Corporations Act and the assessment and franking of dividends paid from 28 June 2010'). On our reading, the Ruling appears to hold that dividends can only be paid from profits and not from 'amounts other than profits', an interpretation supported by recent expert advice. Rather than allaying the concerns identified by Treasury about the ability of companies to pay franked dividends, the Ruling seems in fact to reinforce the discrepancy between the approaches of Treasury and the ATO.

Our underlying concern is that there is little indication that Treasury and the ATO are communicating directly on the practical effects on public companies of the dividends test.

This seeming disjuncture is of considerable practical significance to our clients, who inevitably look to whether a dividend can be franked in determining whether or not it should be paid – a matter of obvious consequence to shareholders.

In our view, regardless of which approach to the dividends test Treasury adopts, it would be desirable for Treasury and the ATO to work together to ensure a consistent approach.

Freehills Head Office Advisory Team January 2011