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Our ref Comment letter - DP Corporations Act

30 January 2012

Dear Sir/Madam

Comment letter - Discussion Paper: Proposed Amendments to the Corporations Act

We are pleased to have the opportunity to comment on the proposed amendments to the Corporations Act detailed in the Discussion Paper *Proposed Amendments to the Corporations Act* released in November 2011.

Executive Summary

In our view, in terms of the options for dealing with the dividend test, Option 2 – 'solvency test' would be our recommendation to move forward and address a number of the current practical difficulties in this most important commercial area.

We have also provided a number of comments on other areas that would benefit from further clarification/consultation including:

- capital maintenance requirements
- application of dividends test to group companies
- Australian Taxation Office Draft Taxation Ruling TR 2011/08
- parent entity reporting requirements
- changing of the financial year of a company
- small companies limited by guarantee.

Please refer to the Appendix of this letter for our detailed comments.

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We would be pleased to discuss our comments with the members of Treasury or its staff. If you wish to do so, please contact me on (02) 9335 7630, or Michael Voogt on (02) 9455 9744.

Yours faithfully

Martin McGrath
Partner In Charge, Department of Professional Practice

Appendix – Discussion Paper: Proposed Amendments to the Corporations Act

1. Test for payment of dividends

Options for dealing with the dividends test

As acknowledged in the Discussion Paper (DP), historically there have been a number of practical implementation issues with the 'old' section 254T 'profits test'. Although the revised section 254T 'net assets test' may have dealt with some of those issues, as the revised section has been applied in practice, it has become increasingly apparent that it has its own implementation issues.

Therefore, in our view, all of retaining the revised section 254T (Option 1); or reverting back to the 'old' section 254T (Option 3); or providing a choice between either of these (Option 4) are not desirable or feasible outcomes.

Option 2 'solvency test' is, in our view, the most workable outcome for a number of reasons:

- Neither the Corporations Act or the Income Tax Assessment Act defines 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 accounting standards, which are increasingly linked to fair values. This causes unnecessary costs and difficulties for directors when considering dividends and was one of the principal drivers for the change in the *Corporations Amendment (Corporate Reporting Reform) Act 2010* (Reform Act). We also note that 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.
- Both the profits test and the assets exceeding liability test based on accounting standards are not absolute indicators of solvency. Adopting a solvency test, based on all assets and liabilities, regardless of whether they are recognised for accounting, in determining whether a dividend can be paid provides a higher level of comfort to directors in complying with their obligations under section 588G to prevent insolvent trading.
- The solvency test is a concept that directors are already familiar with, given all companies required to prepare annual financial statements must also prepare a directors' declaration about the financial statements (section 295(4)), which includes a 'solvency declaration' in line with the section 95A solvency test.
- Current accounting standards may result in more volatile accounting profits with the recognition of some non-cash and unrealised fair value movements. Further, a company may still have sufficient cash reserves to pay a dividend but may not have sufficient accounting profits – for example a company whose major asset is an intangible asset which produces positive cash flows and whose fair value is appreciating. Under accounting standards the company is not able to reflect the fair value appreciation in the financial statements (no active market) and will need to amortise the asset over its useful life (non-cash expense). Similarly, an assets exceeding liability test based on accounting standards may not permit the payment of dividends where assets such as intangible assets cannot be recognised at fair value.

- Option 2 is similar to the New Zealand requirements which have been used successfully for some time. Further, it is consistent with the Trans-Tasman agreement between the two countries to harmonise corporate law requirements.
- A 'solvency test' may also be considered to reduce the regulatory burden of the Corporations Act. Further, if Corporations Act dividends are able to be franked it may reduce the regulatory burden for income tax purposes. However, the 'solvency test' may not provide a link into accounting standards – for example asset valuations may not be recorded in the financial statements.

If Treasury decides to proceed with other than Option 2 then we would recommend that further guidance is need to clarify the following practical issues:

- Do assets and liabilities need to be determined in accordance with Australian accounting standards? Do entities that are not mandated by the Corporations Act to use Australian accounting standards (for example small proprietary companies) have to apply Australian accounting standards to determine their dividends?
- When should the timing of the testing be performed? When declared, determined, paid or at each date (if applicable)?
- Whether the test needs to be performed by the individual company paying the dividend or if it can be performed on a group basis? This issue is discussed further below.
- The interaction between section 254T and Chapter 2J of the Corporations Act (see further discussion below).

Use of 'declared'

The language in the DP for Option 2 implies that the 'solvency tests' would be performed when the dividend is paid. Our preference is that it is made clear that any solvency test should be performed when the dividend is paid. Therefore further clarification for companies that 'declare' or companies that 'determine' dividends should not be needed.

However, if Treasury does not proceed with Option 2 then we would recommend that the use of the language in the redrafting of section 254T should cater for both companies that declare or determine a dividend. Furthermore, the section should also clearly outline the timing of when any test(s) should be performed, i.e. on declaration, determination, payment or all of the above that are applicable.

Capital maintenance requirements

In the DP, Treasury has expressed a view that it considers that the test for paying a dividend in the current section 254T ***is*** a circumstance where a reduction in capital is 'otherwise authorised' by the law.

There has however been some debate as to whether the current section 254T is restricted by the capital reduction provisions in Part 2J.1 of the Corporations Act. Legal opinion has in some circumstances indicated that a ‘section 254T dividend’ ***may not*** be a reduction in capital ‘otherwise authorised’ by the law.

This has been highlighted by taking the following hypothetical example into account - the directors wish to declare a dividend of $30,000 however the company has a balance sheet of $100,000 of cash and share capital only.

Under the current section 254T it could be argued that all three tests are met. However, the current section 254T only states that if the three tests are not satisfied then the company cannot pay a dividend. We have seen in a number of instances where current legal opinion suggests that it does not automatically follow that if all three tests are satisfied that a dividend can be paid, i.e. the provisions of the capital reduction provisions in Part 2J.1 of the Corporations Act also need to be considered.

The above current legal opinion is also consistent with the views expressed in the opinion attached to Australian Taxation Office Draft Taxation Ruling TR 2011/08.

Therefore the view expressed by Treasury in the DP would appear to be at odds with current legal opinion.

KPMG therefore supports further clarification in the Corporations Act to remove these current uncertainties, i.e. a positive statement that a dividend which complies with section 254T is a circumstance where a reduction in capital is ‘otherwise authorised’ by the law.

Application of test to group companies

It is our view that currently the dividend test applies at each individual company level. So if a dividend is paid by a subsidiary to an intermediate parent (IP) then the IP also needs to determine whether it satisfies section 254T. Only if it does can the IP pay the dividend further up the ownership chain to the ultimate parent who in turn pays dividends to the owners (i.e. public). If dividends cannot be paid up the ownership chain so called ‘dividend traps’ are created.

KPMG would strongly support consultation and clarification in the Corporations Act of the following practical issues:

- When measuring assets and liabilities should it be conducted at each individual entity level or should it be completed at the group level?
- If at a group level what are the impacts of groups that may have:
  - guarantee arrangements for all or part of the group?
  - formed a tax consolidation group?
- What impact would there be on any dividend test for groups that have no formal cross guarantee between all entities within the group in place?
- How would a Corporations Act dividend test applied at a group level interact with the taxation treatment of dividends?

In our view it would be preferable for some form of cross guarantee to be in place if the dividend tests were to be applied/or could elected to be applied at the group level. This would assist directors in discharging their duties under section 588G to prevent insolvent trading.

The above comments equally apply no matter which option is selected for dealing with the dividend test.

Taxation issues

The DP provides the following statement in respect of the intended taxation consequence of the Corporations Act amendments in 2010.

> "When the Corporations Act was amended in 2010 to allow dividends to be paid in circumstances where a company's assets exceed its liabilities, it was expected that there would be no significant change to the circumstances in which dividends could be franked for income tax purposes. In particular, it was expected that dividends that could be franked prior to the 2010 changes could continue to be franked after those changes."

In December 2011 the Australian Taxation Office issued Draft Taxation Ruling TR 2011/08 which included an opinion that has made a number of comments surrounding the application of the current section 254T. While we welcome the draft tax ruling it highlights that there are a number of differing views that need to be addressed. The 'solvency test' (Option 2) should address the issues from the Corporations Act perspective. However, further consultation is also needed on the income tax side.

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

The current asset exceeding liabilities test has presented a number of practical implementation issues and returning to a profits test would not remove the uncertainty which was a principal aim of the 2010 amendments. The movement to a 'solvency test' (Option 2) with clarification around the capital reduction provisions in Part 2J.1 of the Corporations Act (discussed above) should provide necessary clarification around dividends for Corporations Act purposes.

However, as a simultaneous process, the consequences of this change on the Income Tax Act should commence. We would not want to delay the redrafting of section 254T for the income tax process.

Commercially the ideal situation would be that dividends for the purposes of the Corporations Act are capable of being franked for income tax purposes. We would welcome amending the tax legislation to simplify this area, albeit we recognise that the revenue implications of our ideal situation might preclude the Government from adopting this course of action.

2. Other issues for consideration

Parent entity reporting requirements

In our view, Class Order 10/654 provides flexibility for those entities required to present consolidated financial statements that wish to include parent entity financial statements as part of their financial report. The Class Order may be considered an interim measure and so the Corporations Act should be amended as a permanent resolution. In our view there should be no restrictions placed on circumstances where an entity may decide to prepare parent entity financial statements.

Another issue that we recommend that Treasury addresses is the situation where a consolidated group prepares special purpose financial statements. As a consolidated group preparing special purpose financial statements is not required by accounting standards to prepare consolidated financial statements, it can be technically argued that such a consolidated group cannot utilise the relief provided by section 295(2)(b). This is based on the current wording of Regulation 2M.3.01 (3) read with section 295(2) (b) which only permits consolidated financial statements and the exemption from parent entity financial statements if consolidation is required by the ***accounting standards***. AASB 127 *Consolidated and Separate Financial Statements* states that consolidated financial statements are only prepared by reporting entities. Entities, including consolidated groups, preparing special purpose financial statements are by definition non-reporting entities.

In our experience, many consolidated groups prepare consolidated special purpose financial statements, generally for valid reasons such as requests from banks. Such consolidated groups typically would like to take advantage of the parent entity relief, however technically under the wording of current legislation, are precluded from doing so. In practice many such entities are not preparing parent entity financial statements. In our view, extending the relief to whenever consolidated financial statements are prepared in accordance with accounting standards (rather than “required” by accounting standards) is appropriate and would address a significant area of technical and practical concern.

Changing the financial year of a company

We support an amendment to section 323D (2A) to resolve the inconsistency with section 323D (2), i.e. for entities that vary their year end by plus or minus seven days.

In addition to section 323D(2), section 323D(3) requires an entity to synchronise its financial year end with its parent when it becomes a controlled entity. If an entity changes its year end after becoming a controlled entity it may be precluded from applying section 323D(2A) in a subsequent year. This could arise as it may not meet the requirement in section 323D(2A) that there has not been a financial year of less than 12 months during the previous five financial years. For example if three years after being acquired, assuming the entity needed to change its year end from 30 June to 31 December on acquisition, an entity is disposed of and wishes to change its financial year back to say 30 June.

We would therefore recommend that section 323D(2A) be amended to exclude situations where the year end has changed for reasons otherwise allowed by section 323D from the ‘previous 5 financial years’ test.

Small companies limited by guarantee

When assessing whether an entity meets the definition of a small company limited by guarantee, section 45B(1)(c) states *where* the company is required by accounting standards to be included in consolidated financial statements, that the consolidated revenue should be less than the threshold amount (currently $250,000).

Where company A controls subsidiaries B and C, then it is clear, assuming A is a company limited by guarantee, that for A the revenue in the consolidated financial statements is the amount to compare against the defined threshold amount. However, in the above example assume that A and C are large proprietary companies and subsidiary B is a company limited by guarantee – should the revenue test be the:

- revenue of subsidiary B only (as it controls no other entities), or
- revenue of the consolidated A group?

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 Reform Act 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 B only.

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