



6 February 2012

The Manager  
Corporate Reporting and Accountability Unit  
Corporations and Capital Markets Division  
Australian Treasury  
Langton Crescent  
Parkes ACT 2600

**By Email:** [corporatereportingreforms@treasury.gov.au](mailto:corporatereportingreforms@treasury.gov.au)

Dear Sir/Madam,

**Proposed amendments to the *Corporations Act 2001 (Cth)*  
Section 254T – Declaration of a dividend**

The LIV has recently considered the Federal Government's Discussion Paper titled 'Proposed Amendments to the Corporations Act' (**Discussion Paper**), with particular focus on the recent amendments to the threshold test for declaration of dividends. To this end, we set out our comments below.

**Applicable Legislation**

From 28 June 2010, assessment of a declaration of dividends by a company has been based on a three pronged net asset test as set out in section 254T of the Act. A declaration of dividends based on net assets replaced the previous test which required a declaration to be based on profits.

For your ease of reference, the net asset test set out in section 254T of the Act provides as follows:

*Circumstances in which a dividend may be paid*

(1) *A company must not pay a dividend unless:*

- (a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and*
- (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and*
- (c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.*

(2) *Assets and liabilities are to be calculated for the purposes of this section in accordance with Accounting Standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned).*



The LIV has several concerns with the practical application of the above test for payment of dividends, especially in the context of family companies. These concerns include the following:

1. the test for payment of dividends;
2. the test's application to capital maintenance requirements;
3. the test's application to group structures; and
4. the use of the term declared.

Each of these concerns is considered in further detail below.

### **Test for payment of dividends**

Section 254T(2) requires assets and liabilities to be calculated for the purposes of determining dividends payable according to the relevant accounting standards in force at a particular time. This is the case even if the given accounting standard does not otherwise apply to the financial year of some or all companies concerned.

The problem with section 254T requiring dividends to be determined according to relevant accounting standard is that the Explanatory Memorandum to the Act appears to provide a contrasting position. It states that companies which are not required to prepare audited financial reports should determine net assets by reference to accounting records required to be kept under section 286 of the Act. This section requires a company to keep records that enable true and fair financial statements to be prepared.

The LIV is concerned that this inconsistency between the wording of Section 254T(2) and the intention as reflected in the Explanatory Memorandum, may lead to organisations relying on the Explanatory Memorandum (and the reporting requirements for non-reporting entities) thereby authorising financial records *not* to be prepared in accordance with the relevant accounting standards required under section 254T(2).

The LIV is also concerned that as a matter of principle, the requirement to rely on financial reports that calculate assets and liabilities based on accounting principles, is a concern for many, especially smaller companies. If the intention of the section as reflected in the Explanatory Memorandum is not adopted, the Act has mandated recognition and measurement in accordance with accounting standards to entities that would not otherwise be required to incur the expense of reporting in compliance with accounting standards. This would be so even though the Act does not require reporting according to accounting standards for such entities for any other purpose.

When considering the test for payment of dividends in a taxation context, the LIV notes that often small to medium companies are required to contemplate declaring a dividend to avoid adverse taxation consequences. This is especially the case where there are loans to shareholders and their associates (see Division 7A of the *Income Tax Assessment Act 1936* (Cth)). Again, the requirement for such companies to produce compliant accounting statements that would otherwise not be required to do so imposes a further and often onerous burden on these smaller companies.

When considering the test for payment of dividends in an insolvency context, the LIV is of the view that existing insolvency provisions operate to protect creditors from the consequences of declaring a dividend when the company is, or would as a result of the declaration or payment of the dividend, become insolvent (e.g. section 588G of the Act – directors' exposure to insolvent transactions). Should a declaration of a dividend which based on financial statements that do not comply with the relevant accounting standards result in an entity's insolvency, appropriate redress could be available to unsecured creditors arising from a breach of the requirement of Section 254T(1)(c) as well as the insolvency provisions of the Act. This is available under the current net regime for declaration of dividends.

To address the concerns cited above, the LIV believes that legislative amendment is needed to remove the sole reliance on applicable accounting standards for payment of a dividend.

## Capital maintenance requirements

A reduction of share capital requires compliance with Chapter 2J of the Act, including shareholder approval. If dividends can be paid from capital accounts, the question then arises whether the capital reduction process under Chapter 2J must be satisfied before a dividend can be paid under section 254T.

The LIV notes that the Explanatory Memorandum indicates that the net asset test is intended to operate as an exception to the capital maintenance rule, so that declaration and payment of a dividend does not require compliance with Chapter 2J of the Act. However, section 254T of the Act does not explicitly provide for such an exception. Rather, this section has been drafted in a prohibitive sense where a dividend is unable to be paid unless certain tests are satisfied and does not provide for an *authorisation* to pay a dividend if the specified criteria are satisfied. Furthermore, the LIV is aware that both the Australian Securities and Investment Commission<sup>1</sup> and the Australian Taxation Office (ATO)<sup>2</sup> have previously taken the view that it is necessary to comply with Chapter 2J requirements despite the introduction of section 254T.

To address these concerns, the LIV believes that legislative amendment is needed which clearly specifies that payment of a dividend under section 254T does not give rise to compliance obligations under Chapter 2J.

## Application to group structures

The reference to “company” contained in section 254T(1) implies that the net asset position of each company must be considered separately when determining whether to declare a dividend, and that group accounts may not be relied on.

However, the wording of section 254(T)(2) appears to contradict this, referring to “some or all of the companies concerned”. This infers that more than one company may be considered when interpreting section 254T(1). Requiring each company declaring a dividend to satisfy the dividend test implies that where an otherwise profitable and cash flow positive subsidiary has a net asset deficiency due to, for example, loans from the parent company, those loans may need to be capitalised to facilitate a positive net asset position before a dividend can be declared.

To ensure consistency with case law principles and bring certainty to this issue, the LIV believes that legislative amendment is needed to clarify the ‘individual company’ approach in which section 254T applies to group company structures, so that the net asset and solvency tests (e.g. section 254T(1)(c)) must be satisfied by the group, rather than each individual entity in the group. The general insolvency provisions will provide appropriate redress for creditors of a group member with a negative net asset position that declares a dividend and becomes insolvent.

## Timing for determination of dividends

According to section 254T(1), the net asset test for determination of dividends must be met *immediately* before a dividend is declared. As such, directors are unable to rely solely on the company's most recent financial reports to assess if the assets outweigh the liabilities. It is no longer *only* a cash flow issue.

This obligation to declare dividends based on net assets may also impact upon the timeliness with which dividends may be declared, although in most cases it is unlikely that dividends will be declared based on interim management reports, unless the net asset position is clearly healthy.

In addition to impacting on timeliness, this obligation may also affect companies' reporting processes as where a company does not otherwise report in accordance with accounting standards, financial statements may need to be amended to account for these standards prior to declaring dividends.

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<sup>1</sup> Australian Securities and Investments Commission, Corporations Law Amendments Working Party, *Record of Discussion*, 2 September 2010

<sup>2</sup> Australian Taxation Office Draft Ruling 2011/D8, 22 December 2011

To overcome these issues, the LIV believes that companies that do not ordinarily report in accordance with accounting standards should be entitled to rely on the latest financial statements (within prescribed limits) unless directors are, or ought to reasonably be aware, that the net asset position has altered materially in the meantime.

### **Fairness and reasonableness test**

According to section 254T(1), any payment of a dividend must be 'fair and reasonable' to the company's shareholders as a whole. This requirement is not difficult to satisfy where the company has only one class of shares that all have the same dividend rights.

However a company may have different classes of shares with different dividend or other entitlements. The current provisions are therefore unclear as to whether payment of a dividend to one class of shareholders and not to another contravenes the fairness and reasonableness test. Even if this does not contravene the test, depending on the circumstances, the question arises as to whether payment of a dividend to one class of shareholders could be seen to effectively strip the company of surplus assets that may otherwise have been payable to another class in priority on winding up (and therefore may not be fair and reasonable to shareholders as a whole).

The LIV believes that dividends payable to one class of shareholders *in accordance with their terms of issue* should not be considered to contravene this "fair and reasonable" limb and legislative clarity around this issue should be considered.

### **Conclusion and steps forward**

For the reasons set out above, the LIV believes that further legislative amendments to section 254T of the Act are necessary to address the ambiguities which currently exist in the application of this provision and to alleviate the onerous obligations currently imposed on directors in declaring a dividend.

The LIV has considered the options contained in the Discussion Paper for reforming section 254T. In response to these options, the LIV has set out some suggested legislative wording to address the concerns cited above by way of a draft revised provision set out in Schedule 1.

If you would like to discuss any of the matters raised in this submission please do not hesitate to contact me or Angela Gidley, Commercial Law Section Lawyer, on 03 9607 9382.

Yours sincerely



**Michael Holcroft**  
President  
Law Institute of Victoria

## **Schedule 1 – Revised section 254T of the Act**

(1) *A company must not pay a dividend unless:*

- (a) the company's or consolidated entity's assets exceed their liabilities before the dividend is determined to be payable and the excess is sufficient for the payment of the dividend; and*
- (b) the payment of the dividend is fair and reasonable to the company's shareholders and to the shareholders of the holding company in a consolidated entity as a whole; and*
- (c) the payment of the dividend does not materially prejudice the ability of the company to pay their creditors.*

*Note 1: As an example, the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment.*

*Note 2: For a director's duty to prevent insolvent trading on payment of dividends, see section 588G.*

(2) *Assets and liabilities are to be calculated for the purposes of this section:*

- (a) where the financial statements for the company or the consolidated entity are required to be prepared in accordance with Accounting Standards, then in accordance with Accounting Standards in force at the relevant time; and*
- (b) in any other event, by reference to the accounting records which are required to be kept under section 286.*

(3) *In calculating the assets and liabilities for the purposes of this section the company may rely on:*

- (a) the financial statements for the company or the consolidated entity in respect of the last financial year where the dividend is determined within 9 months of the end of that financial year; and*
- (b) in any other event, the assets and liabilities of the company or the consolidated entity by reference to the accounting records which are required to be kept under section 286 as at a date being not more than within 3 months prior to the date of determination of the dividend,*

*in either event, unless the Directors are aware, or acting reasonably should be aware, that the net assets position has altered materially from that recorded in such financial statements.*

(4) *A company that complies with the requirements of subsection (1) shall not be required to satisfy the requirements of Chapter 2J.*

(5) *For the purposes of paragraph (1)(c), when considering a company in a group structure, in the absence of a contract creating some additional right, the creditors of each company can only look to that particular company for payment of their debts.*

(6) *For the purposes of paragraph (1)(b), the payment of a dividend made in accordance with the terms of issue of the shares that favours the payment of one class of shares over another does not, for that reason alone, contravene the requirements of that paragraph.*