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



By email to: corporatereportingreforms@treasury.gov.au

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Dear Sir/Madam

Proposed amendments to the Corporations Act – Further consultation on the dividend test introduced under the Corporations Amendment (Corporate Reporting Reform) Act 2010 (Reform Act)

This submission is made by Macquarie Group Limited and its subsidiaries (Macquarie) in response to the discussion paper on potential further reform of the dividends test introduced under the Reform Act (Dividend Test), which was released by the Parliamentary Secretary to the Treasury on 28 November 2011 (Discussion Paper).

Macquarie is supportive of further refinement of the Dividend Test. We particularly support the proposal under Option 2 in the Discussion Paper, to adopt a solvency test based on the New Zealand approach. The specific issues which we wish to address are:

- the uncertainties created by introduction of the Dividend Test in 2010, which Option 1 would perpetuate;
- refinements to Option 2 which would more closely align the Australian provisions with those under New Zealand law;
- the difficulties of returning to a profit test (Option 3) or combining this with the current balance sheet test (Option 4);
- use of the word “declared” under Option 2;
- clarification of section 254T as an exception to the capital reduction provisions in Part 2J.1 of the Corporations Act;
- amendments to clarify the position for group companies; and
- the need to align the taxation law on franking credits with the recent and any further changes to the dividend provisions under the Corporations Act.

Our comments on each of the alternatives are as follows:

Option 1 – Retaining section 254T as drafted

Macquarie submits that retaining the current Dividend Test is not preferable due to the following areas of uncertainty which this test introduced for Australian companies:

- the “fair and reasonable” test is confusing as it suggests additional rights beyond those dealt with in section 254W (each share in a class having the same dividend rights unless specifically provided otherwise in the constitution or by special resolution);
- the meaning of the term “material prejudice” is unclear in this context and section 588G deals adequately with the situation where payment of a dividend would cause a company to become insolvent (as would a true solvency test like Option 2);
- if dividends are determined at a date other than the reporting date, there is an unreasonable burden on companies to measure the net assets of the company again at the end of the intervening period, as it is unclear what other evidence the directors could rely on in applying the test;
- the current dividend test requires the directors to measure the net assets of the company using Accounting Standards. It does not give directors scope to use their professional judgement in considering current valuations;
- this does not address the problem of which Accounting Standards are to be used when a company either is not required to prepare financial statements, or it prepares special purpose financial statements; and
- it is unclear whether the directors may authorise the payment of a dividend which does not immediately create an obligation to pay the dividend if the balance sheet test is not at that stage satisfied, but they have reasonable grounds to believe that it will be satisfied before the dividend is actually paid.

Option 2 – Adopting a solvency test

Macquarie supports the proposal to adopt a solvency test based on the New Zealand approach. However, there are key elements of the New Zealand approach which are not included in Option 2 and which Macquarie submits should be included. These are:

- the New Zealand test is clear as to *when* the solvency test must be met - requiring the company to be solvent after the distribution is paid (section 52(1) of the Companies Act 1933 (Companies Act));
- in determining whether the New Zealand solvency test is satisfied, directors may give consideration to all the circumstances which may affect the value of the company's assets and liabilities. In this regard directors may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances (Companies Act, section 4); and
- the New Zealand test includes an explicit direction that (absent an express authorisation in the company's constitution) a company's liabilities for the purpose of the test include any amount that would be needed, if the company were to be dissolved at the time of the dividend payment, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution (Companies Act, section 52(4)).

Including the first of these elements in a revised Dividend Test will ensure that the solvency test is to be satisfied at the point in time that is most important from the perspective of

shareholders and creditors – being the time at which the dividend is paid. The *balance sheet* test in Option 2 is clear about this being the most relevant point in time for the assessment. We submit that the solvency test should be brought in line.

Including the second and third elements noted above will give directors the ability to exercise their professional judgement about the company's financial position at (in most cases) the *future* time at which the dividend will be paid. An indirect link to accounting standards can still be maintained whilst providing directors with the flexibility to determine prudent valuations which may otherwise not be available due to accounting standards such as:

- provisions for loan losses based on market deteriorations;
- current valuations of assets that are carried at historical cost for accounting purposes; and
- adjustments for fair value accounting mismatches (e.g. where hedge accounting is not available despite the entity hedging the relevant exposures).

Furthermore, directors should not be limited to applying measures at a fixed *past* point in time, being the balance date of the most recent financial statements or section 286 records.

We note that there are other international precedents for these elements of the New Zealand approach, including Canada and the United States. We do not accept the view expressed under Option 2 that the absence of an express link to the accounting standards in the New Zealand test is a disadvantage of adopting that approach. By requiring directors to have regard to the most recent financial statements (prepared in accordance with accounting standards, if applicable) or financial records kept under section 286, a revised Dividend Test in line with Option 2 would provide clarity and certainty to the decision making process, particularly if there is discretion for directors to have regard to valuations of assets or estimates of liabilities that are reasonable in the circumstances. Overlaying such discretion (should it be included) would be directors' current duties of care, diligence and good faith under sections 180 and 181. These provisions set a high standard for director conduct which provides protection for shareholders and creditors against misapplication of appropriate valuations.

Option 3 – Reinstating the profits-based test

We do not support this option which we consider would be a retrograde step given the widely accepted drawbacks of this approach. The latter include the absence of any definition of profits in the Corporations Act, the volatility introduced by increasing requirements to use fair values under accounting rules where there is an accounting mismatch, and the inconsistency with the approach in other major economies.

Option 4 - Combining a profits test with the current balance sheet test

Although a hybrid approach based on our suggested refinements to Option 2 may have some value as an alternative to adopting the New Zealand approach, we do not give our primary support Option 4. This proposal retains the disadvantages of the profits test and the current balance sheet test, and fails to direct attention to the most important issue from the perspective of shareholders and creditors, namely whether the company will remain solvent after the distribution is made. Even if these drawbacks are overcome, allowing companies to choose from alternative tests will lead to complexities such as difficulties for investors and creditors seeking to understand and compare the approach of different companies' to paying dividends.

Other matters

Use of 'declared'

The Discussion Paper states Treasury has come to the view that, except where the dividend test is a solvency test (Option 2), there may be merit in bringing the terminology used in section 254T into line with the terminology used in section 254V and most company constitutions. We consider that making this change is imperative as this would correct a drafting error which has left section 254T out of step with most modern company constitutions. However, we do not support the continued use of 'declared' should Option 2 be adopted. If a solvency test is adopted, the section should say (as does section 52 of the Companies Act) that the company must not pay a dividend unless the board is satisfied on reasonable grounds that the company will, *immediately after the distribution*, satisfy the solvency test. As noted above, the time of declaration of the dividend is not the critically important time, and many companies are not constitutionally able to declare a dividend.

Capital maintenance requirements

We submit that the drafting of section 254T does not support Treasury's opinion that this section is excluded from the provision of Part 2J.1. In our view what is needed is a positive statement that if the requirements set out in section 254T(1) are satisfied, the company may pay the dividend notwithstanding that it reduces its share capital by doing so.

Application of test to group companies

We support the proposal to clarify how the Dividend Test applies to corporate groups. One solution would be to enable ASIC to modify, or grant exemption to, the law so that, for example, if there is a deed of cross-guarantee in place for group entities, the balance sheet or solvency test (as the case may be) could be assessed on a group basis.

Taxation issues

The draft Taxation Ruling released by the Australian Taxation Office on 21 December 2011 has left unresolved the current inconsistency between section 254T and the franking rules. Indeed the draft ruling effectively reinstates the profits test by enabling franking only where a dividend represents a distribution of "booked" profits. We submit that resolving this inconsistency is a matter for legislation, as was the approach with amendments to the Income Tax Assessment Act (1936) associated with the 2010 amendments to section 254T. Amendments to the taxation law are essential to ensure a consistent policy outcome is achieved for both tax and corporations law under any of the suggested advancements on the current Dividends Test.

Yours sincerely

[Signed: by email]

Patrick Upfold
Chief Financial Officer
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