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

2 February 2012

Dear Sir

Submission on the Treasury Discussion Paper dealing with "Proposed Amendments to the Corporations Act"

We are pleased to respond to the above Discussion Paper. While the broad objectives of the 2010 Corporations Act changes were to provide greater flexibility to companies to make dividend distributions to their shareholders, the uncertainties surrounding the operation of those changes have resulted in additional impediments to companies. In our view, further legislative change is required to address these issues.

Our responses to each of the issues raised in the discussion paper are included in the Appendix.

We would welcome the opportunity to discuss our views at your convenience. Please contact Jan McCahey on (03) 8603 3868 to discuss issues relating to accounting and financial reporting, Andrew Wheeler to discuss legal issues on (02) 8266 6401 or Wayne Plummer on (02) 8266 7939 to discuss taxation issues.

Yours sincerely

Jan McCahey

Jan McCahey
Partner
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Appendix

Test for payment of dividends

Stakeholders are invited to provide their views about each of the four options listed in this paper (including an indication of their preferred option or options).

Are there other options for dealing with the dividends test that could be considered by Treasury?

In our view, the preferred option is "Option 2 – Adopting a Solvency Test":

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; and

• the company will continue to be able to pay all the company's debts, as and when they become due and payable (see section 95A of the Act — the solvency test).

In determining whether the company's assets will exceed its liabilities after the dividend is declared, the directors shall have regard to:

• the most recent financial statements prepared in accordance with section 295 of the Act; or

• the financial records kept by the company under section 286.

We recommend adoption of Option 2 because:

- We support a solvency test and supported the current dividend test when it was proposed in the Corporations Amendment (Corporate Reporting Reform) Bill 2010, however we agree that amendments are needed to address the practical issues highlighted by the Discussion Paper. In our view Option 2 plus our other recommendations in this letter address these issues;

- The principle underlying the dividends test should be based on solvency. Option 2 is not a pure solvency test but is the closest of the options provided to a solvency test. Option 2 is also broadly consistent with the approach taken in New Zealand.

Other issues identified in respect of the dividend test

Use of "declared" in Section 254T

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.
In our view the concept of *declaration* of a dividend should be removed as an element of the dividend payment test. The use of this term has created considerable uncertainty around the ability of companies to determine dividends, a process that has been explicitly permitted by the Act pursuant to Section 254U.

In our experience, companies commonly choose to determine dividends given the flexibility provided by the determination process. Determination of dividends may be more appropriate than the declaration of dividends if, for example, the directors wish to pay a dividend at a future point in time subject to the satisfaction of a condition (such as the receipt of monies from a customer or the receipt of a dividend from a subsidiary). Determination also allows a company to revoke a dividend prior to the date for payment of that dividend as, pursuant to Section 254V, a debt is not incurred by the company until the time for payment of the dividend arrives.

If the dividend payment test in Section 254T continues to include a net assets test, we recommend that the test be modified such that the directors of the company must satisfy themselves immediately prior to a debt being incurred in respect of the dividend that the company's assets will exceed its liabilities when that debt is incurred. We note that Section 254V already governs the timing of incurrence of a dividend related debt.

The practical effect of this modified test is that companies will retain the flexibility to either determine or declare a dividend. If the company declares a dividend, the directors must satisfy themselves immediately prior to the declaration that the company's assets will exceed its liabilities when that dividend is declared. If the company determines a dividend, the directors must satisfy themselves immediately prior to the time fixed for payment of the dividend that the company's assets will exceed its liabilities at that time. In each case the directors would be required to consider what the financial position of the company will be when a debt in respect of the dividend has been incurred.

Capital maintenance requirements

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.

In our view, it should be explicitly clarified in the legislation that any dividend paid in accordance with Section 254T is, where the effect of the dividend may also be to reduce the capital of the relevant company, a circumstance 'otherwise authorised by the law' for the purposes of Section 256B(1).

We do not agree with the Treasury view that the current section 254T is clear and we recommend that it is clarified.

We note in this regard the following comments made in the joint opinion to the ATO by AH Slater QC and JO Hmelnitsky:

> *"The new s 254T, however, does not authorise any act: it merely prohibits some acts. A dividend may not be paid unless the company's assets thereafter exceed its liabilities, the dividend is "fair and reasonable" to members as a whole and creditors are not prejudiced. That is not the same proposition as that a dividend may be paid if those conditions are satisfied."*

Application of test to group companies

Stakeholders' comments are sought on whether a modification is needed to the manner in which the dividends test applies to group companies to address the situation where an intermediate holding company cannot satisfy the net assets test and, potentially, stops dividends flowing to the parent company.

We recognise that the situation described in the Discussion Paper may arise, but in our experience there is not a widespread problem. When companies encounter this issue, many are able to resolve it and pay a dividend: For example, some companies in a net liability position due to a large loan from a parent entity have been able to renegotiate the terms of the loan such that it is converted from a liability to equity. In our view the dividends test should continue to apply on a separate entity basis.

If the Treasury is minded to modify the dividends test for intermediate holding companies, relief should not be available to insolvent entities (or those that might become insolvent after paying a dividend) which are protected by a deed of cross guarantee, because:

- A deed of cross guarantee does not provide positive financial support, it is simply a protection of last resort which is activated if a company that is party to a deed becomes insolvent;
- If an intermediate holding company is or becomes insolvent when paying a dividend, other group companies that are party to a deed of cross guarantee would become liable for the insolvent intermediate holding company's debts. In this situation the payment of a dividend by the intermediate holding company is potentially prejudicial to creditors of another group company; and
- To determine whether an intermediate holding company is able to pay a dividend, its directors would be required to assess its effect on all other group companies that are parties to the deed of cross guarantee, which would present practical difficulties in many groups.

We do not recommend that the dividend test references consolidated accounts.

Taxation Issues

We recommend, as a matter of principle, that the ability of a company to frank a dividend should be matched to provisions determining whether a dividend is to be included in assessable income.

The current section 44(1A) of the Income Tax Assessment Act 1936 ("the Tax Act") provides that "a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits". If this provision has the effect of extending the scope of dividends that may be included in assessable income, then the ability to frank dividends should correspondingly be extended.

In that regard, we note the comments in the joint opinion provided to the ATO by AH Slater QC and JO Hmelnitsky. If the current section 254T does not authorise the payment of a dividend, there should be no circumstances in which the current section 44(1A) of the Tax Act can have effect.

If section 254T is to be amended to ensure that it authorises the payment of dividends otherwise than out of profits, then the taxation outcomes should be to either:

(i) retain section 44(1A) to specifically include such dividends (other than those debited to share capital) in assessable income and to introduce a new provision in the imputation rules to specifically enable all such assessable dividends to be frankable apart from the application of certain integrity rules; or

(ii) omit section 44(1A) from the Tax Act so that any dividends not paid "out of profits" will not be assessable.

In addition, we recommend that section 202-45(e) of the Tax Act be amended to ensure that its operation is limited to its originally intended scope. Section 202-45(e) currently provides that a dividend will be unfrankable if it is "sourced directly or indirectly from a company's share capital account".

According to the Explanatory Memorandum which introduced section 202-45(e), the operation of the provision is to prevent an amount from being a frankable distribution if it is debited to an entity's share capital account or represents an amount transferred from the share capital account to another account to facilitate its distribution.

We also refer to the following comments in relation to section 202-45(e) made in the joint opinion provided to the ATO by AH Slater QC and JO Hmelnitsky.

> *".... neither the language used by the parties, nor the entries made in the records, will determine whether the operation of s 202-45(e) is attracted.*
>
> *In our view, "sourced" in this context means appropriated from or referable to. We do not think it requires, or is limited to, the causal connection which the High Court discerned in the words "attributable to profits" under consideration in FC of T v Sun Alliance Investments Pty Ltd (in liq) (2005) 225 CLR 488. Rather, in our view, it directs attention to the equity fund which is depleted by payment of the distribution....*
>
> *We think the cases where s 202-45(e) applies and there is not an avowed or misdescribed return of capital will be rare, if they can exist, and that it is likely that the words "or indirectly" have little practical operation save perhaps to make it more apparent that mere verbiage or ledger entries do not resolve the issue."*

While we acknowledge the view that a court should "read-down" the scope of section 202-45(e) as set out above, the broad current drafting of the provision provides significant potential for it to be mis-applied beyond its intended scope. Such potential was evident in the release by the ATO of its Draft Fact Sheet "The new section 254T and the franking of dividends" released on 21 June 2011.

We therefore recommend that section 202-45(e) be amended to either:

> (a) remove the words "or indirectly"; or
>
> (b) replace the words "sourced directly or indirectly from a company's share capital account" with "sourced from a company's share capital account or from an amount previously transferred from such an account".

Other amendments

Stakeholders' are invited to comment on:

- ***whether an amendment which allows companies, registered schemes and disclosing entities that are required to present consolidated financial statements to also include parent entity financial statements as part of their financial report under Chapter 2M of the Act would adequately address their concerns about parent entity financial reporting?***
    - ***Under such an amendment, the preparation of parent entity financial statements would be optional for all entities that are required to present***

consolidated financial statements. Should any restrictions be placed on the circumstances in which an entity may decide to prepare parent entity financial statements?

- ***whether there are other parent entity financial statement-related issues that they consider should be brought to the Treasury's attention?***

Parent entity reporting requirements

We agree that subsection 295(2) should be amended such that the preparation of parent entity financial statements would be optional for all entities that are required to present consolidated financial statements. In our view no restrictions should be placed on the circumstances in which an entity may decide to prepare parent entity financial statements.

Non-reporting entities and parent entity financial reports

In relation to the parent entity reporting requirements, we also note that there is currently some uncertainty in relation to the application of the revised section 295 of the Act to non-reporting entities:

Section 295 was revised to enable an entity to avoid preparing separate entity financial statements, if the accounting standards require it to prepare consolidated financial statements. Section 295 requires all other entities to prepare separate entity financial statements.

Most Australian Accounting Standards only apply to reporting entities, which are defined as entities "in respect of which it is reasonable to expect the existence of users dependent on general purpose financial statements for information which will be useful to them for making and evaluating decisions about the allocation of resources" (AASB 1053 Appendix A). AASB 127 *Consolidated and Separate Financial Statements* does not apply to non-reporting entities, and this means that prima facie these entities are not required to prepare consolidated accounts. ASIC confirmed in Regulatory Guide 85 *Reporting requirements for non-reporting entities* (RG 85) that non-reporting entities do not need to prepare and lodge consolidated financial statements if neither the parent entity nor the group is a reporting entity. However RG 85 also reminds directors of the Act's requirement for financial reports to give a true and fair view and requires directors to consider the need to make disclosures which are not directly prescribed by accounting standards but may be necessary in order for financial statements to give a true and fair view. Some non-reporting entities choose to prepare consolidated accounts because their directors consider it necessary to provide users of the accounts with a true and fair view.

Some commentators interpret section 295 as requiring non-reporting entities to prepare separate entity financial statements in all circumstances, including where consolidated financial statements are also prepared. In our view this subjects non-reporting entities to more onerous reporting requirements than reporting entities. If a non-reporting entity considers consolidation necessary to provide users of the financial report with a true and fair view, then we believe the entity should be exempted from preparing separate entity financial statements, consistent with its reporting entity peers.

The Act should be amended to clarify that non-reporting entities are permitted to replace the separate entity financial statements with a note disclosure if they choose to prepare consolidated financial statements. This could be done, for example, by revising section 295(2) as follows:

The financial statements for the year are …

(b) if the accounting standards require the company, …. to prepare financial statements in relation to a consolidated entity or the directors choose to prepare financial statements in relation to a consolidated entity…

Changing the financial year of a company

Stakeholders' are invited to comment on whether there are other issues associated with the requirements for changing the financial year of a company that they consider should be brought to the Treasury's attention?

We agree that the inconsistency within section 323D in relation to a financial year that is up to seven days longer or shorter than 12 months should be addressed. We do not have any other comments in relation to the new rules on changing the financial year of a company.