

Greenwoods & Freehills

Tax Brief

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Distribution clarity?

In our recent Tax Brief on distribution confusion [[ATO continues the distribution confusion](#)], we discussed two fact sheets that the ATO had circulated in draft dealing with the impact of the 2010 changes to the *Corporations Act 2001* dividend rule in section 245T and the associated tax law change. Most concern revolved around the conclusion that a dividend which produced or increased negative retained earnings was assessable for tax purposes but unfrankable to the extent it represented negative retained earnings. The reasoning for this conclusion left us and many others scratching their heads in confusion.

Clarity may – emphasise may – be about to return with the release of a Discussion Paper by Treasury on further possible amendments to the Corporations Act and a communication from the ATO which seems to retract in part the conclusion in the draft fact sheets.

Further change to Corporations Act

The Discussion Paper refers to the problems that have been reported by 'stakeholders' in relation to the 2010 corporate law amendments and offers four possible approaches to them. The first is a do nothing option, that is, leave the 2010 changes in place. The third is the exact opposite – repeal the 2010 change, and go back to the former 'out of profits' test.

Neither seems likely to address the problems that have been identified with these approaches. The former requires recourse to accounting standards even by companies which do not have to prepare accounts in accordance with such standards. The latter reinstates the problem of uncertainty about the out of profits test and the fact that IFRS was producing large swings in accounting profits and losses which made payment of smooth dividend streams more difficult for large companies using the standards.

The other two alternatives seem to involve three distinct ideas. One option is to keep the 2010 rule and to reinstate the pre-2010 out of profits rule as an alternative that could be satisfied in relation to the payment of a dividend. The other option is to adopt a solvency test along the lines of New Zealand.

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The third idea which appears in both of these options in different forms, is to deal with the problem of requiring the use of accounting standards by companies which are not required to prepare accounts under the standards. In the solvency test option the reference to accounting standards is removed entirely. In the alternative tests option companies required to use accounting standards would measure assets and liabilities in accordance with the standards, while for other companies the measure would be based on the financial records required to be kept under the *Corporations Act 2001*.

These options are expressed in quite abstract terms and so do not relate directly to the kinds of specific concerns that have arisen under the 2010 corporate law amendments, in particular whether it is possible to pay a dividend by creating negative retained earnings. So it is not immediately clear what the answer to that question is under any of the options.

Treasury does provide its own answer to another question that has been raised under the 2010 corporate law change – that it is possible to pay a dividend which is debited to share capital. However, directors still may not be prepared to rely on an ‘after-the-fact’ view of the legislation put forward in a Discussion Paper. There would be doubt about whether a Court could or would take that into account in interpreting section 254T itself.

Tax consequences

The Discussion Paper proposes to leave the tax issues created by the 2010 corporate and tax law changes to the ATO. It states that Treasury expected that there would be ‘no significant change to the circumstances in which dividends could be franked for income tax purposes’. It goes on to note that under the ATO fact sheets ‘a company is unable to frank dividends out of current year profits if its net assets are less than its share capital’.

As indicated in the Treasury paper the issue was dealt with at a recent meeting of the ATO Public Rulings Panel. Subsequently the ATO circulated the relevant NTLG subcommittee that it was decided at the meeting to issue a ruling containing the following propositions:

- A company dividend paid without breaching section 254T will be an assessable, frankable distribution if it is paid out of current trading profits, regardless of a company having prior year losses or a deficiency of net assets below share capital.
- A company dividend paid without breaching section 254T will be an assessable, frankable distribution if it is paid out of unrealised capital profits recognised in a revaluation reserve, provided a company’s share capital is intact (that is, net assets do not go below share capital).

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- The profits must be available for distribution by way of dividend, and be recognised in the proper accounts of the company kept in accordance with the Corporation Act and accounting standards, and calculated pursuant to them.

This seems in the first bullet point to retract the broad proposition in the draft fact sheets but only in one case, where there are current year profits (even if overall the company has negative retained earnings). If a company has no current year profits and no past year positive retained earnings it seems that the dividend will still be regarded as unfrankable by the ATO as being in effect out of share capital.

The Discussion Paper and ATO communication say nothing about the flow on consequences of the apparent ATO preference for a debit to share capital account (as a loss reduction under section 258F of the Corporations Act) in cases involving negative retained earnings.

The second bullet point confirms what was already accepted in the draft fact sheets that distributions out of revaluation reserves are frankable.

The third bullet point requires that the profits in both cases must be in accounts prepared under the accounting standards, which extends the existing problem of the new corporate law for companies which are not required to prepare accounts in accordance with accounting standards. The companies that do not need to prepare IFRS accounts are generally small businesses for which IFRS accounts can be a considerable burden. Hopefully this problem will be addressed as a result of the Treasury Discussion Paper.

The main problem which many submissions have sought to fix is that dividends should be able to be debited to negative retained earnings generally and be frankable. The outcome of the Discussion Paper is unlikely to provide a definite resolution on that issue. As the ATO seems unwilling to change its view except in cases of current year profits, this issue is unlikely to be resolved unless a taxpayer is willing to litigate the matter.

We will continue to monitor this problem, especially the draft ruling to be released by the ATO, as it is creating unnecessary problems for taxpayers.

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